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FOREWORD

These proceedings record the papers presented at the Twelfth Annual Institute on Accounting of The Ohio State University held in Columbus May 19 and 20, 1950. Herein, also, is recorded the story of the establishment of The Ohio State University Accounting Hall of Fame, and the first three living accountants elected to that distinction. The names of George Oliver May, Robert Hiester Montgomery, and William Andrew Paton have been permanently inscribed upon the roster of this, the only known Hall of Fame devoted to those whose contributions to the profession of accounting have been outstanding. They were selected for this distinction by the Board of Nominations. Details of the procedure and a list of members of the 1950 Board of Nominations will be found in the record of the proceedings at the fourth session of this Institute.

Approximately 480 persons registered for this conference. Participation by members of local, state, national, and international organizations of accountants followed the pattern of prior years. In addition, many business executives and others were in attendance. The gratitude not only of the faculty and administration of The Ohio State University but also of the entire audience at the various sessions is here expressed to the chairmen of sessions, speakers, and other participants in the program. And to all who contributed to the success of this 1950 Institute, the sponsoring organization extends a warm expression of appreciation.

HERMANN C. MILLER
Chairman, Department of Accounting

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FIFTH SESSION

FIRST SESSION

FRIDAY, MAY 19, 1950—10:00 A. M.
Deshler-Wallick Hotel

Presiding:

EDMUND A. CLARKE, *President, The Ohio Society of Certified Public Accountants; Haskins & Sells, Cleveland*

Paper: "The Federal Incentive Income Tax Plan"

FRANK WILBUR MAIN, *Partner, Main and Company, Pittsburgh*

Paper: "The Effect of the Capital Gain and Loss Provisions on Business and Investment Decisions"

ARTHUR B. MOLL, *Partner, Van Benschoten, Moll & Flaskal, New York City*

INTRODUCTORY REMARKS

CHAIRMAN CLARKE: It is both a pleasure and a privilege for me to welcome this distinguished gathering of accountants, educators, and others who have come here to participate in the Twelfth Annual Institute on Accounting of The Ohio State University.

For many years before the current series of the Annual Institute on Accounting was organized, the Ohio Society of Certified Public Accountants held a regular spring meeting on The Ohio State University campus. I believe this practice dates back to 1920. Since the inauguration of the Annual Institute, members of the Ohio Society have generally been continuing their visits to these meetings. The Society has since been augmented by members of the National Association of Cost Accountants, the Controllers Institute, the Institute of Internal Auditors, the American Accounting Association, and the American Society of Women Certified Public Accountants.

For the last two years, the attendance has been such that the facilities on the campus have been unequal to accommodating the large numbers participating. An extensive building program is being undertaken and it is hoped that in 1951 we can again return to the campus with comfortable quarters for all visiting members.

We are fortunate in having with us at this, our first session, two speakers well versed in their respective subjects. Mr. Main will speak on the "Federal Incentive Income Tax Plan," and Mr. Moll on the "Effect of the Capital Gain and Loss Provisions on Business and Investment Decisions."

Mr. Main is a Certified Public Accountant and has been in practice for almost half a century. He has been active in the development of the Certified Public Accountant profession and has been instrumental in fostering many innovations in the education field; he established the first accounting course at the University of Pittsburgh as early as 1908. The State Board of Public Accountants were the beneficiaries of his service for many years. In addition, he has written many articles on accounting and taxes. As a matter of fact, if I were to recite all of his accomplishments and contributions to our profession, he would have no time to speak for himself. It gives me great pleasure to present Mr. Frank Wilbur Main.

THE FEDERAL INCENTIVE INCOME TAX PLAN

By Frank Wilbur Main
Partner, Main and Company, Pittsburgh, Pennsylvania

The Federal Incentive Income Tax Plan has been before the country for the past five years and has been subject to wide discussions, including opposition as well as commendation. The plan first presented to Congress and to selected groups in April, 1945, was based on two years' careful research and specialized study by my partners and myself, preceded by more than thirty years' experience, both extensive and intensive, in the field of federal taxation. Since that time there have been three revisions of the plan, the last being that of April, 1950. No change has ever been made in the Plan's basic philosophy or structure. Modifications appear only in the proposed exemptions and rates of taxation.

The Federal Incentive Income Tax Plan is based on an entirely new concept of federal taxation, namely, the taxation of income rather than the taxation of individuals and corporations. This taxing of income automatically simplifies the tax structure. Identical rates for individuals and corporations, with the same general exemptions, same graduations, and same ceiling, and the freeing of dividends from taxation in the hands of the recipients are the highlights of the Plan. This simplified tax structure, if adopted, will completely neutralize the question of whether business is done as a corporation, a partnership, or an individual.

Specifically, this tax plan will eliminate what are probably the greatest sources of difficulty and controversy in our present income tax structure. These are:

1. The taxing, at different rates, of identical amounts of income, depending solely on the manner in which the business is conducted.
2. The reasonableness of salaries and other compensation of corporation officers who are also major stockholders.
3. All the questions in respect to unnecessary accumulation of surplus.
4. The double taxation of dividends.

While the achievement of simplicity in the tax structure was a primary purpose in the devising of the Federal Incentive Income Tax Plan, it was secondary to the recognized necessity of bringing about incentive in our national economy.

This incentive can be induced by raising exemptions so that there will be more income in the hands of all taxpayers. We have, especially, in mind those who are dependent on fixed incomes, from pensions or otherwise, and are therefore unable to adjust their incomes to the inflationary trend. This is only one part, however, of the incentive feature. The other is to place a ceiling on the taxation of any income, and thus to provide funds for investment, both in already established concerns and in new and risk-taking ventures.

Specifically, we would raise the exemption of single individuals from $600 to $1,000; married couples from $1,200 to $2,000; and corporations to $2,000; but leave the exemption for dependents at $600. The graduated scale of taxes we propose ranges from 15 per cent on net taxable income, after all allowable deductions and exemptions, to 50 per cent on all net taxable income over $50,000. By placing a limit of 50 per cent on any part of taxable income by freeing dividends from taxation, a substantial incentive is provided for investment.

The freeing of dividends in itself would not only bring about increased investment, but would also probably result in relieving sound companies from fixed indebtedness. Investors, in our opinion, would much prefer a dividend on which they pay no taxes to interest on which they do pay taxes. In such cases, Uncle Sam would not lose anything, inasmuch as the interest is now free of taxation to the corporation but is subject to taxation of the recipient; on the other hand, under the Federal Incentive Income Tax Plan, the dividend income would be subject to taxation on the corporation but would be free of tax on the recipient.

Inflation can only be leveled off and controlled, we believe, by increased production. This involves two factors: first, increased ability to buy on the part of all citizens, and second, increased investment on the part of those with surplus income.

You may be interested in the background and philosophy of the Federal Incentive Income Tax Plan and in the response which we have received to it.

In April, 1945, we stated that the present federal taxing structure needed a complete overhauling rather than amendment and adjustment which would only further complicate an already very complex system of taxation. Our present tax structure is geared to war economy. What we must have is a taxing philosophy patterned for years of peacetime living.

Let me briefly review our federal taxing structure and the factors that have controlled its development.

As early as 1909, we had an excise corporation income tax. In 1913 the income tax amendment to the Constitution was passed, and graded income taxes became possible. These taxes, however, did not amount to much until 1917, when the impact of World War I brought about the necessity of drastic increases in taxes, with the resultant high normal and surtaxes for individuals, and high normal and excess profits taxes for corporations. The 1918 Act increased the taxes still more.

In the years that followed, there were reductions and then further increases, culminating, during World War II, in the very high normal taxes and surtaxes for individuals and normal, surtaxes, and excess profits taxes for corporations. In addition to these taxes, there were the Victory Tax on individuals and the capital stock tax on corporations. One major objective of all these very high taxes was to siphon off the income of individuals so they would not have the money to buy the articles and products that either did not exist or were very scarce. Another objective was to take away from the corporations all excess profits, so that they would not profit unduly from wartime activities.

During the war period, a single person with a net income of $1,500 before personal exemption paid a federal tax of $230; a married couple without dependents with a net income of $2,500 paid a federal tax of $360. In the case of high individual incomes, the rates rose to in excess of 90 per cent. The rates for corporations rose to extremely high percentages. The purposes were sound and the desired results were attained. As an indication of the accomplishment of these taxes, the number of tax returns increased from approximately 7 to 8 million in 1940 to 40 odd million in 1945.

The excess profits taxes on corporations have been eliminated; likewise we no longer have the Victory Tax. There have been some adjustments in exemptions and tax rates, and we now have the benefit of split incomes for married couples. For the calendar year 1950, it is estimated that under the present law there will be about 55 million income tax returns.

Under the Federal Incentive Income Tax Plan, with our assumption of national income for the year 1950, there would be about 35 million income tax returns, or approximately five times the number in 1940. We would relieve 20 million taxpayers of income tax liability.

You may well ask, "Why should there be 20 million fewer income taxpayers?" Our answer to that is, first, that income taxes are threatening the living standards of many in the lower economic brackets; and second, that citizens with the lower incomes pay the greater part of the excise taxes. By the way, those excise taxes now approximately equal the total income of the Federal Government from all sources in the year 1940. In other words, an amount equaling all the federal receipts in 1940 is now being paid through the taxes on amusements, tobacco, liquor, gasoline, and the various miscellaneous excises. It is at once apparent that these taxes are largely paid by those in the lower income groups, because of the simple fact that they comprise most of our population.

The first Federal Incentive Income Tax Plan proposed in April, 1945, was based on a postwar national income of 160 billion dollars, and a federal budget of 25½ billion dollars. Other tax proposals made at that same time were based on a postwar national income of 100 billion dollars, with a possibility that it might reach 125 billion dollars. These plans were also generally based on an assumed federal budget of from 16 to 18 billion dollars. Why were we so far out of line with other proposals in our assumptions of national income and federal budget? Let me cite some economic background.

The national income, during the period from 1932 to 1940, had varied from approximately 40 billion dollars to 78 billion dollars. The highest national income this country had ever had before World War II was that of 1929, namely, 83 billion dollars. The federal budget, during this same period, viz. from 1932 to 1940, had varied from approximately 4 billion to 9 billion, the government "take" averaging approximately 11 per cent per year. Our federal debt, which had been on an almost stationary level of 2½ billion dollars from the Civil War to the First World War, had increased to 25½ billion as a result of World War I. Along with many other Americans, I personally, was much concerned by this great increase. The late Andrew W. Mellon, Secretary of the Treasury, advocated a reduction in income taxes at the close of World War I. This advice was followed, and the tax incentives resulted in expanded business, which produced sufficient government revenue to reduce the debt in a few years to 16½ billion dollars. Then came the '30's and at the time that we entered World War II, our debt was approximately 45 billion dollars. However, we were a richer country than I had realized in 1918 and 1919, and this debt was handled more easily than I had anticipated.

With the advent of World War II, it was necessary to win, whatever the cost. We estimated in April, 1945, that our federal debt would reach approximately 300 billion dollars. Our studies also convinced us that with this debt, our obligations to our veterans, a large Army and Navy, and many other additional expenses, the minimum budget that we could expect would be at least 25½ billion dollars.

How were we going to raise a budget of 25½ billion? Incomes such as we had in 1932, 1940, or the 100 to 125 billion dollars predicted in 1945 would not yield that sum. During the period from 1932 to 1940, as already stated, the government "take" had been approximately 11 per cent per year. We figured that the government could take perhaps 15 per cent without permanently endangering the national economy. With a budget of 25½ billion dollars, and a government "take" of 15 per cent, a national income of at least 160 billion would be required.

We now doubt very much that the government can continue to take as much as 15 per cent without further puffing up our income through inflationary forces. In 1946, before the national income reached 160 billion, we went on record in Washington and elsewhere stating that the national income would go to 160 billion dollars and beyond. We were certain that without a sound incentive tax plan, geared to peace, the national income could not be held at this figure, and that we would be faced with ever-rising inflation until such time as we had a sound taxing plan, together with economy in our national administration. A sound taxing plan is not the only step necessary for the elimination of inflation and for the establishment of a sound economy, but, in our opinion, it is a vitally important one. It should be followed closely, perhaps it would be better to say accompanied, by economy in the administration.

While, in 1945, our plan was based on a national income of 160 billion, our current revision is based on the assumption that personal income in 1950 will amount to 237 billion 500 million, and that there will be 35 billion of corporate compiled net profits. Whether or not we seem to be a little high in our estimate today does not greatly matter, because the inflationary forces are still at work, and if our forecast is high today, it will, we believe, be low before too much time has elapsed.

We thought that we could anticipate the criticism which we would receive and the reaction of the public and interested groups. We felt that such criticism would center largely around the complete freeing of dividends and the placing of a limit of 50 per cent tax on any income. This did not prove to be the case.

The first criticism was a protest that in the postwar period it would be impossible to have a national income of 160 billion dollars. You will recall that there was a great deal of agitation in the closing months of the war to make certain that our national income did not drop too drastically and thus bring about mass unemployment. The New York *Sun*, on June 1, 1945, had a very interesting review of the Plan. The editorial writer stated, however, that inasmuch as the Plan was based on an assumed national postwar income of 160 billion dollars, it was quite impractical. The writer did, however, commend a private citizen for interest in this matter.

There was also a great deal of criticism in respect to an assumed budget of 25½ billion dollars. I was practically referred to as an advocate of government extravagance. The passage of time has more than taken care of these two criticisms.

There was likewise an abundance of criticism in respect to raising the exemptions. Many then thought that everybody ought to pay some share of the cost of the government; that feeling is still prevalent today. Actually everybody does pay his share of taxes, through the multiplicity of hidden taxes. The fact seems to be overlooked that if we are to have a sound, healthy economy, as well as a decent and equitable society, we must leave sufficient incomes in the hands of all citizens, and particularly those dependent on pensions and other fixed incomes. The inflation has already gone so far that even if such people are completely relieved from taxation, a fixed income of $100 per month, which at one time was a rather substantial amount, will not now provide any great comfort.

Perhaps the feature of our proposal which has been most disputed concerns our desire to raise the corporation tax on all taxable income over $50,000 from the present 38 per cent to 50 per cent. The principal objection to this is due to the theory shared by many that corporations actually do not pay taxes—they only pass them on. Our answer to this is that all taxpayers pass their taxes on as much as possible. The workman asks for increased wages; corporations raise their prices; and the professional man endeavors to raise his fees. All succeed to a certain extent, but nobody is very well satisfied with the manner in which he passes on taxes. There is one great group, however, that has not been able to pass on the taxes, and that is the pensioners and the others who are dependent on fixed incomes.

One answer to the criticism against raising corporation taxes has been that the government has to have a certain amount of money. While our original plan and the first revision provided for a ceiling of taxation of 50 per cent, we felt, just before the cold war became quite hot, that with the reduced government spending which then appeared to be in the offing, the maximum ceiling could be reduced to 40 per cent. This is the percentage that we had planned to propose on our second revision, but with the changed conditions, such a maximum would not have been honest, since it would not have provided sufficient revenue.

Even with a maximum of 50 per cent on corporations, our studies also convinced us that corporate stockholders would be better off for several reasons. In the first place, their dividends would be free of taxation. Secondly, if the individual paid no more than 50 per cent on any part of his income, it would not be necessary for such large salaries to be paid at the higher levels. With an economy expanding on a sound basis, we are also convinced that a 50 per cent tax on the corporate income would be better than the 38 per cent which has been expanding very largely through inflationary forces.

While there has been some criticism of the Incentive Income Tax Plan, there has been a great deal of commendation, also. More and more citizens are becoming interested in it. We are naturally quite pleased that *Life* magazine, in its February 13, 1950, issue referred to this Plan as one of four proposals now under consideration. We were also pleased with articles by Mr. G. A. Price, President of Westinghouse Electric Corporation, in reference to the Federal Incentive Income Tax Plan which appeared in *Fortune* and *Coronet* magazines. While many in Washington and elsewhere know about the plan, this is a tremendously large country and many still are not acquainted with it. If you believe the plan is meritorious, and that its enactment would be a good thing for our country, I hope you will say so to your senators and congressmen.

THE EFFECT OF THE CAPITAL GAIN AND LOSS PROVISIONS ON BUSINESS AND INVESTMENT DECISIONS

By Arthur B. Moll
Partner, Van Benschoten, Moll & Flaskal, New York, New York

Perhaps without exception, the one section of our income tax system which commands most attention is that which covers the capital gain and loss provisions.[1] Tax men, lawyers, and accountants have concerned themselves to a great extent with these provisions in order to gain the best tax advantage for their clients. Businessmen and investors alike are relatively careful to consider the possible effects, tax-wise, of everything they do which may remotely or otherwise be affected by these capital gain and loss provisions.

This, of course, is understandable. Any section of a taxing system which gives a tax advantage, such as that covering capital gains and losses, is of necessity given careful study by all concerned. This paper, therefore, will review the capital gain and loss provisions with the primary objective of determining how they have affected cases in the past, and how these effects influence future decisions.

Brief History

The "Capital Gain" provision was first introduced by the Revenue Act of 1921, and has appeared, with changes, ever since. It was intended primarily to save from excessive taxation the profits of individuals derived from the sale or exchange of capital assets which represented an increase in value over a period of 2 years or more.

The "Capital Loss" provision in the Revenue Acts of 1924, 1926, 1928, and 1932 limited the deduction for such a loss to 12½ per cent of such loss, the same rate at which gains were taxed.

The Revenue Act of 1934 abandoned the theory of taxing capital gains on an entirely separate basis, but many of the provisions of the prior acts were retained, such as the definition of capital assets and the length of period such assets were held. The 1934 Act provided that capital gains were subject to the surtax brackets, with certain limitations dependent on the period for which the assets were held. There was also a further limitation on the amount of losses allowable, and this applied to corporations as well.

The Revenue Act of 1936 continued the principle of including a percentage of taxable capital gains in income and followed the 1934 Act, except as to the treatment of distributions in liquidation.

The 1938 Act and the Internal Revenue Code made several important changes, particularly in the holding periods and the percentages taken into account. In general, much that is basic in the present law and regulations was developed from the 1938 Act.

A substantial change was made in the Internal Rvenue Code by the Revenue Act of 1942. It is this act with which we concern ourselves at the present time, except for timber-cutting provisions which were added by the 1943 Act.

Keep in mind, however, that the decided cases have much to do with interpreting the doubtful provisions and borderline situations. These cases, therefore, as well as Treasury decisions and other official pronouncements, must at all times be considered in evaluating a course of action affecting business and investments.

Also, one eye must be kept on future trends and proposed legislation. We will explore those implications later.

Summary Outline of Present Law

A summary outline statement regarding the capital gain and loss provisions of the present law is perhaps advisable at this time in order to provide a background picture for the discussion of the specific situations which follows.

First, there must be a capital asset, and second, there must be a sale or exchange. These two elements are conditioned by the holding period, the interim which elapses between the time of acquisition of the asset and its sale or exchange.

If held for a period greater than six months, it is labeled long-term and only 50 per cent of the gain or loss is taken into account. If held for a period of six months or less, it is called short-term, and 100 per cent of the gain or loss is taken into account. The net gain or loss of each class is combined after applying the percentages. The resulting net gain, if any, is included in net income. The net loss, if such is the case, may be used to offset the individual's ordinary income, with a maximum limit of deduction of $1,000 in any one year. For corporations, no percentages are applied to long-term gains or losses, and further, corporations are not permitted to deduct any net losses.

Net losses disallowed in any one year may be carried over and applied to net capital gains of the next five years for individuals and corporations alike, with a further deduction allowance of $1,000 each year for individuals.

The alternative tax calculation effectively limits the tax on long-term capital gains to 25 per cent of such gain for both individuals and corporations.

A capital asset is any property held by a taxpayer (whether or not connected with his trade or business), except the following:

1. Stock in trade or other property properly included in inventory if on hand at the close of the taxable year.
2. Property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business.
3. Depreciable property used in a trade or business.
4. Real property used in a trade or business.
5. Federal, state, and municipal obligations issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from date of issue.

Special treatment is accorded to certain property used in the trade or business of the taxpayer which is sold, exchanged, or involuntarily converted after being held for more than six months. If gains from such transactions exceed the losses, they are treated as long-term capital gains. If losses surpass the gains, the excess is deductible as an ordinary loss.

The capital gain and loss provisions are effective only where there has been a sale or exchange. We shall see later that what sounds like a simple statement can actually be quite complex. A sale or exchange can be many things, such as retirements and redemptions, distributions in liquidation, debt adjustments, involuntary conversions, worthless stock losses, foreclosures, and even the cutting of timber.

Thus—stated briefly—we have a pattern which can be used to govern our detailed consideration of many of the features of this important part of our taxing system and its effect on business—and investment—decisions.

When is "Property" a "Capital Asset"

The negative definition of a capital asset, by which a capital asset is broadly all property owned by the taxpayer except certain exclusions, gives rise to many interesting situations. Of course, if a gain is involved, it is to the advantage of the taxpayer that the asset not be numbered in these exclusions.

The seller of securities ordinarily has no specific problem here unless he is a dealer or underwriter. The sales made by dealers to customers in the ordinary course of business are not sales of capital assets. Activities with respect to securities which do not involve the merchandising of securities constitute trading or investment. The sales made by traders and investors alike are considered sales of capital assets, but traders are not subject to wash sale provisions. The difference between traders and investors depends on the extent of activity. An investor may operate on a large scale merely because he is wealthy. A trader may operate on a much smaller scale, but because they constitute his main source of living and consume most of his time, his activities are considered "trade or business." An individual *may* be a dealer and an investor at one and the same time, but both types of activity must be separately followed.[2] Thus, a specialist in certain securities may purchase a quantity of the stock in which he deals, keep it separate from his regular holdings of the stock, and hold it for over six months in order to realize long-term capital gain. Complete segregation must necessarily be effected.

An interesting situation has arisen in the case of livestock producers. Even though certain animals used for breeding purposes are usually included in inventory, the fact that they, for a time at least, are kept to produce offspring led to the ruling in a decided case that the sale of these animals produced capital gain.[3] Bureau rulings[4] held that an unusual or abnormal sale of breeding livestock, or a sale in reduction of the breeding herd, is the sale of a capital asset. These rulings, on the other hand, further held that the normal year-to-year sales of animals used once for breeding purposes are sales of animals held primarily to customers and are, therefore, productive or ordinary income. The case mentioned above held these exceptions invalid, but this is not the final word, because the commissioner will not acquiesce and will litigate all similar cases.

The sale of patents is another situation wherein the Bureau and the taxpayer are dueling for the best tax effect. Aside from other considerations, the basic principle involved is whether or not the patent has been merely "licensed" or completely "assigned," thus constituting a sale or exchange.[5] It is important to note that a person who is a regular inventor may be considered in the business of inventing and selling patents; in his case, the capital gain section does not apply.[6] Only the amateur inventor can be considered to have realized capital gain on the sale of his patent, which has in his case become a capital asset.[7]

This is likewise true in the case of copyrights. We know that General Eisenhower is not a professional writer, and hence, when he sold his memoirs, he was allowed the benefits of the capital gain provisions. On the other hand, a professional writer could not consider his copyrights as capital assets when he sold them to his publishers.

When the creators of the characters, Amos and Andy, sold their program to the Columbia Broadcasting System, the Treasury Department issued a letter-ruling that the program was a capital asset, and the sale resulted in capital gain. What was the result? It seems that everyone who could consider himself even remotely in a similar situation tried to cash in on it. As a matter of protective policy, the Treasury switched and ruled against Jack Benny when he sold his stock in a corporation which handles the Benny Radio Program. The merits of the Benny case have yet to be settled, and in the opinion of this writer, there is much to be said for his case and it should eventually be settled at least in part in his favor.

A business, as a going concern, is not considered a capital asset,[8] but when sold it must be split into its component parts and each treated separately. If one of the component parts is goodwill, it must be clearly indicated as such and the amount allocated to it should not be uncertain.[9] On the other hand, a partnership interest is a capital asset for tax purposes, even though made up of mixed assets.[10] We know, also, that the interest of a co-owner of a corporation, i.e., a stockholder, is a capital asset. Thus, it would appear that the single proprietor is in an unfair position.[11] This is emphasized in the case of a man who buys out his partner. The selling partner has sold a capital asset, but, thereafter, the buying partner's interest is not considered as such. Perhaps we have not heard the last of this seeming disparity.[12] The matter of allocating the selling price of a business to its various components has the effect of pricing the capital assets and goodwill at as high a figure as possible by the seller in order to gain the best tax advantage. Here, then, is just one more situation where all other economic considerations are overshadowed by the attempt to minimize taxes through the medium of the capital gain and loss provisions.

Real property not used in a trade or business is a capital asset. The consideration of real property problems in connection with the capital gain and loss provisions has had the effect of bringing more cases to the courts than any other controversy. This is understandable if we examine some of the issues raised.

A personal residence of the taxpayer is a capital asset, although a loss on a sale is not usually deductible. If, however, the residence is abandoned as such and is rented, it becomes property used in the trade or business of the taxpayer, even though the taxpayer is engaged in other trade or business.[13] This same rule has been applied to property acquired for investment purposes.[14] A real estate dealer, who ordinarily was engaged in the sale of houses and lots in subdivisions, had at the same time a number of houses which he held for the rent income they produced. These rental properties he later sold and the Tax Court upheld his contention that the sales produced capital gains.[15] This is comparable to the case of the securities dealer whose personal investments are held to be capital assets, even though the holdings are otherwise similar. This rule, however, has worked against another taxpayer who sought to deduct a loss in full by virtue of Section 117(J). This section permits the deduction, as an ordinary loss, of losses sustained upon the sale of "real property used in the trade or business of the taxpayer." In the case in question, the taxpayer was in the lumber business. He purchased unimproved lots which he attempted to sell to prospective home builders to whom he could subsequently sell the necessary lumber. Because such a few sales were made, the taxpayer unloaded the property at a loss. The Court held that the loss was deductible only as a capital loss because the lots were not held for sale to customers in the ordinary course of the taxpayer's business; the fact that the lots were acquired as incident to the taxpayer's lumber business and were used to the fullest extent possible was completely ignored.[16] A more fortunate taxpayer was once engaged in the business of "raising, buying and selling livestock" and acquired some acreage for grazing purposes. The acreage proved unsuitable for this purpose and was rented, pending a sale. A later sale resulted in a loss which was allowed as an ordinary loss because the property was acquired originally for business purposes and not as a casual investment.[17] The effect of these decisions, which seem to be in conflict, will be to cause taxpayers in similar circumstances to move with caution and to stringently strengthen their cases. Quite often, when a decision is diametrically opposed to a preceding ruling, we find that the taxpayer has tried his case on the wrong theory, leaving the court no alternative but to decide against him.

A word of caution here might be worthwhile. The intention of a taxpayer to do something does not carry sufficient weight in the courts to swing a decision in the taxpayer's favor. In one case, a taxpayer purchased vacant land with the idea of erecting a business building. He prepared his plans and applied for a permit. His application was denied because of a zoning ordinance. Some years later, he sold the land and tried to deduct a full loss under Section 117(J). The court held that this section does not apply because the property was not actually used in the taxpayer's trade or business.[18] The Second Circuit has upheld the Tax Court in a decision holding that the mere intention to convert residence property to rental property, even though accompanied by expense incurred for that purpose, is not sufficient provocation for deduction.[19]

Consideration of commodity deals brings us face to face with the subject of dealings in futures and hedges. Losses on commodity deals are usually considered under three main headings: (1) hedges, (2) wagering contracts, and (3) regular capital investments. Wagering losses are allowed only to the extent of gains from other wagering contracts. Losses from sales of commodities acquired as investments are subject to the limits of the capital gain and loss provisions. The losses from hedges, however, are fully deductible. To be considered a true hedge, the deals must be more than remotely connected with the business of the taxpayer.[20] A true hedge is considered to be one which was entered into for the purpose of protection against a business risk, rather than for speculation.[21]

Necessity for Sale or Exchange

As pointed out earlier, in order to have a capital gain or loss, it is necessary to have a sale or exchange. The term, sale, can be considered in the ordinary meaning of the term. There must be a buyer and a seller and an agreement by both parties as to the terms of the sale. Forced sales, such as mortgage foreclosures and tax sales can be considered as coming within the definition. The term, exchange, ordinarily means the reciprocal transfer of assets, or, as stated in one case, "mutual grant of equal interests, the one in consideration of the other," implying that the term is almost synonymous with "barter."[22] We shall see that the terms are construed very broadly and take in transactions which do not come within the ordinary meaning of "sale or exchange" but are considered to be such because the effects are similar.

Amounts received by the holder upon the retirement of bonds, debentures, notes, certificates, or other evidences of indebtedness issued by a corporation (including those issued by a government or political subdivision thereof), accompanied by interest coupons or in registered form, shall be considered as amounts received in exchange therefor.[23] The term, retirement, is not limited to the final payment of an obligation.[24] Partial payments of principal have been held to be within the statute.[25] Furthermore, it has been held that the surrender of bonds or debentures, for payment of a fraction of their face value by a debtor in financial difficulty, is considered a retirement.[26] It is to be noted that the above provision covers only certain specific types of securities. Those which do not come within the section are a bond and mortgage given to secure a loan,[27] a promissory note,[28] and interest coupons detached from bonds and redeemed at maturity.[29]

Short sales of securities are not deemed to be consummated until delivery of securities to cover the short sale.[30] Gains or losses attributable to the failure to exercise options to buy or sell property shall be considered as short-term capital gains or losses.[31] Both of these rules, in their application to investors, have done much to clear the air and remove a great deal of the doubt which previously existed.

Losses sustained by reason of the worthlessness of stocks and bonds are held to be considered as losses on the sale or exchange of capital assets; the sale or exchange is considered as having occurred on the last day of the year. This, of course, is true only if the stocks or bonds are in themselves capital assets and do not include those held as stock-in-trade or for sale to customers.[32] Banks come under a special rule regarding losses on bonds and similar securities.[33] The securities of an affiliate are excepted from this rule and are deductible in full on becoming worthless.[34] The right to receive shares of stock which have not as yet been issued, although paid for, has been held to come under this same rule.[35]

Gains and losses from partial and complete liquidations are both treated as capital gains and losses and offer no specific problems today such as existed when partial liquidations were treated separately.

Property which by definition and actual usage is considered a capital asset will produce a capital loss through sale or foreclosure. However, if the property is abandoned, the full loss is deductible.[36] Even if the property was not a capital asset, but was depreciable property or real property used in the trade or business, it may be to better advantage to abandon rather than sell. A loss on a sale or exchange of such property which had been held over six months must be applied against gains from sales or exchanges of similar property. The effect would be to reduce the amount of gains which would be taxed at capital gain rates. On the other hand, abandonment would be considered separately and the full loss allowed without reducing the amount of other gains taxed at capital gain rates. The rules to be followed when considering abandonment should be carefully studied and strictly adhered to in advance of taking such a step.

The Holding Period

Because the period of holding the capital asset has its own importance in these considerations, we shall do well to look at some of its pertinent phases. The burden of proof is on the taxpayer to show how long he has held the property. The capital gains and losses section could not be invoked without evidence as to the holding period.[37] The word, "held," means "acquired and held" and is synonymous with ownership.[38] In computing the holding period, the day the asset was acquired by the taxpayer is excluded and the day on which it is sold is included.[39] The rule governing securities which are purchased and sold through stock exchange transactions states that the dates of trade, not the dates of settlement, constitute the dates of acquisition and disposition.[40] The Bureau has set up a number of rules to be used in determining the holding period of capital assets under this section of the code.[41] In general, the period during which an option to purchase stock is held is not added to the period subsequent to actual acquisition upon the exercise of the option. Furthermore, the holding period starts the day after exercising the option.[42] For patents, the holding period is determined by the date on which the invention was put into use or the date when the patent was issued, whichever is earlier.[43]

There are a number of statutory extensions of the period of actual holding. As a general rule, the holding period goes back to the date of its acquisition by a prior owner or to the date of acquisition of prior-owned property if the property sold or exchanged takes as its basis a substituted basis, that is, the prior owner's basis, or the basis of the prior-owned property.[44]

Where a taxpayer exchanges property in a transaction in which no gain or loss is recognized, and the property has the same basis in the hands of the transferee as in the hands of the transferor, the holding periods of the transferee and the transferor are added together. Thus the holding period of the property received in a tax-free reorganization includes the holding period of the property exchanged therefor, even though the latter property was not a capital asset.[45]

Property acquired by a beneficiary of an estate is held to have been acquired at the date of death in the case of property which the decedent owned and at the date of purchase of the property by the executors or trustees, where such was the case. An estate holds the property only from date of death and the period of ownership by the decedent is not added.

Where property was acquired by gift or transfer in trust after December 31, 1920, the period for which the property was held by the donor must be added to the period held by the donee.[46] However, the commissioner holds that where the value at the time of the gift is used to determine the loss, the holding period of the donor and the donee may not be added together.[47]

In the case of wash sales on which loss is disallowed, the holding period of the stock acquired in such wash sale transactions includes the period of ownership of the stock, the loss on the disposition of which is not deductible.[48]

The holding period of stock acquired in the exercise of stock rights shall in every case date from the day on which such rights were exercised.[49]

"Rights" in this case mean only those arising out of stock ownership and should not be confused with "options."[50]

An involuntary conversion is considered as an exchange of the property converted for the property acquired upon the conversion, with the result that the holding period of the converted property will be added to the holding period of the property acquired upon the conversion.[51]

Where a taxpayer sells property which he received as a distribution in kind from a partnership by virtue of his interest as a partner, the holding period dates back to the date at which he acquired the partnership interest or to the date at which the partnership acquired the property, whichever is later. The holding period of a partner's interest in a partnership starts from the date of acquisition of such interest, which of itself is a capital asset and is not to be confused with the date of acquisition of the individual assets held by the partnership. Incidentally, the death of a partner does not interrupt the holding period of the other partners' interests, provided the operation of the business continues.[52]

Effect on Business Decisions

Up to now, this paper has dealt with many specific situations which in each individual case have had their primary effect on the one taxpayer in question. It is these specific situations which form the basis of background knowledge which is used, or should be used, by other taxpayers in arriving at business and investment decisions.

Today, no taxpayer in business, whether individual, partnership, or corporation will undertake any important steps outside the ordinary course of business without determining in advance just how such steps will be affected by the capital gain and loss provisions. Questions will constantly arise which should be answered properly before the event, rather than after a costly course has been decided upon. Shall a no longer useful piece of property be sold or should it be abandoned? Shall a transaction be undertaken now or would it be better to wait for some future time? Is it advisable to take certain steps now to add to the status of a situation in order to place it in a proper category? These, and similar questions, are appropriate ones to ponder before making business decisions, but it is likewise just as important that other economic considerations be given their proper emphasis. It would certainly not be wise to delay a transaction in order to gain a tax advantage which may be slight when compared to the loss of economic advantage caused by the passage of time. Prudence dictates that all sides of each question be given their proper weight before arriving at a decision regarding any business project.

Effect on Investment Decisions

The effects on investment decisions are more directly ascertainable. The holding period is more easily controllable and a taxpayer with any portfolio of investments at all can in many cases pair off the right amount of losses to offset gains, or the right amount of gains to offset losses simply by making a sale and a repurchase of the same security. Constant vigilance over the holding period is recommended in order to determine whether or not 50 per cent or 100 per cent of the gain or loss would be desirable. Periodic examination of an investment portfolio consistently reveals situations wherein it is economically desirable to sell a certain security. Immediate thought of the capital gain and loss status will almost always indicate that an additional sale, a delayed sale, or a switch would help to equalize the tax burden.

A loss carry-over situation will always have its effect on the decisions to take a profit now rather than wait and perhaps lose the maximum benefit which that carry-over can give. There is certainly no excuse for a taxpayer to lose the benefit of an unused loss carry-over, provided however that he does have potential paper profits. This is likewise true of the taxpayer who has both paper losses and paper profits, and if he should be in the ideal position of having short-term losses to offset twice as many long-term gains, there is no question at all about the proper thing to do.

An investor who is at all familiar with the security trading techniques will make full use of short sales to extend a less than six month period to a long-term basis. Furthermore, there are situations in which the price of a security reflects the possibility of a distribution of cash in payment of back dividends and the like. To wait for the distribution would make the dividend taxable as ordinary income, whereas to sell before the distribution would enable the gain to be taxed at capital gain rates. One should avail himself of year-end situations; for example, a year when there is lower than usual ordinary income would be the ideal time to take advantage of some paper profits by selling and repurchasing, thereby increasing the basis for those stocks with a minimum tax effect.

In actual practice, observation of investors' activities indicates that not as much emphasis is placed on the tax situation as one would suppose. To begin with, most investors are not too well versed in the techniques of using short-sales and other devices to minimize tax effects. The problem of doing the correct thing with securities to realize gains and minimize losses is complex enough for the average investor, and the tax considerations become secondary. Only the very active large-scale investor or trader makes the capital gain and loss provisions part of his regular every day considerations in the handling of his securities. By the same token, *every* investor, for his own protection, should know at least the first principles of the issues involved.

Effect on the Bureau

There is no doubt that the capital gain and loss provisions have put the commissioner in the position of being constantly on the defensive. The tax advantage given by these provisions has meant that there is a constant effort by some taxpayers to stretch the intent and meaning behind the code to take into its provisions income which *should* be taxed as ordinary income. Every device which attempts to get around the law immediately sets up Bureau defenses which in the long run will have a tendency to weaken the structure by which legitimate capital gains are fairly given special consideration. The publicity given to some of the temporarily successful devices to give capital gain treatment to what otherwise would be taxed as ordinary income has the effect of creating the illusion that the capital gain provisions are unfair and not proper tax justice. Nothing could be further from the truth.

Pending Legislation

With every session of Congress comes a new batch of revenue legislation. Some of the bills introduced this year contain amendments to the section of the code which affects capital gains and losses. One bill[53] attempts to clarify the situation which now confronts those whose business is raising livestock for draft, dairy, or breeding purposes, by giving them the special treatment under Section 117(J) for property used in the trade or business of the taxpayer. Another bill[54] would create a new holding period class to include distributions upon the endowment or surrender of life insurance policies to the owner or the beneficiary during the lifetime of the assured, if such distribution takes place more than 9 years after issuance. A third bill[55] would tax only 40 per cent, instead of 50 per cent, of long-term gains and would reduce the alternative tax to 16 per cent instead of 25 per cent. In this year of deficit financing, this revenue-reducing bill probably has little chance of receiving more than passing notice.

With this peek into the future, we leave this important subject with the thought that although it is quite proper at all times to keep taxes at a correct minimum, abuse of the privilege given by the capital gain and loss provisions will have the effect of reducing the benefits which were intended to be fairly applied.

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THIRD SESSION

FRIDAY, MAY 19, 1950—2:30 P.M.
Deshler-Wallick Hotel

Presiding:

EDMUND A. CLARKE, *President, The Ohio Society of Certified Public Accountants; Haskins & Sells, Cleveland*

Paper: "Multiple Plant Accounting"

C. E. HEADLEE, *Controller, Westinghouse Electric Corporation, Pittsburgh*

Paper: "Cost Control and Cost Reduction—The Fundamental Responsibility of the Industrial Accountant"

LOGAN MONROE, *President, The National Association of Cost Accountants; Eaton Manufacturing Company, Cleveland*

INTRODUCTION

CHAIRMAN CLARKE: Our first speaker this afternoon, Mr. Headlee, is controller of the Westinghouse Electric Corporation. Starting in the cost department, he has either performed or managed every phase of accounting in his organization. I am very pleased to present Mr. C. E. Headlee whose subject for discussion is entitled "Multiple Plant Accounting." Mr. Headlee!

MULTIPLE PLANT ACCOUNTING

By C. E. Headlee

Controller, Westinghouse Electric Corporation, Pittsburgh, Pennsylvania

Professor Miller—I know him as Captain Miller of the U. S. Navy Cost Inspection Service—had his colleagues spend many hours tracing transactions and costs from one Westinghouse plant to another during the war. Maybe he assigned this subject to me to see if he could uncover some interplant profit in the costs of U. S. Navy orders. Seriously, I do not think that was the reason he selected the subject and I am going to politely accept the assignment as a compliment to the Westinghouse Electric Corporation for their handling of this difficult cost problem on Government C.P.F.F. and negotiated price contracts. Captain Miller and his colleagues in the Navy, Army, and Air Corps inspection service did a splendid job holding the war cost down. Even if they did reconnoiter and attempt to demolish some just claims, I think that, in general, business recovered nearly all of its costs. As you well know, it is to the advantage of everyone of us to develop a cost and pricing system on government business that recovers cost, but no more than cost, with a reasonable profit, one that also rewards the low cost producer for his superior skill. We spend much time talking about this subject, not because of disagreement on the fundamental, but because we have not yet properly catalogued and understood all the elements of cost.

However much the federal government may have prosecuted big business, the government and the public have benefited immensely from the fact that purchases from larger corporations mean the exclusion of profits as the material and goods progress through various steps of manufacture. This is of importance to the consumers and to the economy.

Only a few publications that I have located are devoted to the subject I am attempting to discuss. A Harvard Press publication by James W. Culliton on the subject, "Make or Buy," is devoted to one angle of it. The words, "multiple plant accounting," may infer exclusion of subsidiary or affiliated companies from the discussion, but I do not think that that was the intent. The Westinghouse Electric Corporation has only two manufacturing subsidiaries and one of these is quite small; they are wholly owned. The corporation has about 26 divisions located in 21 plants, 34 repair shops, about 120 sales offices, two wholly-owned sales subsidiaries, wholly-owned Westinghouse Radio Stations, Incorporated, and a few other quite small wholly-owned subsidiaries. I am sure Captain Miller knew this organization picture in a general way, at least, and probably anticipated that the discussion would center around the 21 plants. Experience and problems with these plants will certainly influence and may dominate what I have to say on an even greater extent than I realize.

I would like to make brief and elementary mention of accounting reports to S.E.C., to stockholders, to the banks and creditors, and to the public, with respect to the relative merit of consolidated statements vs. statements of the holding or parent company and of the subsidiaries. My comments in this connection will be limited to the problem as it applies to wholly-owned subsidiaries. I subscribe to the theory that corporations in businesses that are dissimilar should seldom be consolidated. For example, should the statements for Wrigley Park be consolidated with those for the chewing gum business if both are a significant part of the total? In some instances, statements of two manufacturing companies may be so dissimilar as to make consolidation inadvisable, yet if they were two units of one company, they would be consolidated; that idea prevails for all dissimilar activities even to the point of Wrigley Park and chewing gum.

The sales corporation distributing the product of a parent manufacturing corporation might advisably be consolidated with the manufacturing corporation, but I hardly think that Wrigley Park could be considered as a distributing agency for chewing gum. By the word, "distributing," I do not mean "depositing underneath and on the back of chairs." In my opinion, if the consolidation is a proper one and there is an important volume of interunit business, the consolidated statements are generally more revealing than are statements of the individual companies including the parent, unless the set of statements clearly discloses the volume and profit on intercompany business. Consolidated statements, where the consolidation is logical and does not destroy comparisons with previous years, are, I believe, the more revealing. The previous concern of creditors, and investors also since subsidiaries are a distinct entity at law, continues to be an important consideration in favor of statements of the parent and subsidiaries, particularly in the areas where the owners and managers are not known for their reliability. As stated previously, however, such statements may disclose very little unless they show the volume, cost and price practices, and profit on the interunit business.

Of course, I agree with the accepted practice that inventory values on consolidated statements should exclude intercompany profits, but I would like to ask two questions. Should the intercompany profit excluded be profit after or before federal income tax? Having been impressed by the earlier session on taxes, I must digress to "beat one drum a little." You have heard the story that in 1913 when the Federal Income Tax amendment was being proposed, one of the senators suggested a top or maximum tax of 5 per cent. The proposal was belittled and dismissed with the thought that it was ridiculous to think the tax would ever be that high. It was unfortunate that the accountants of that day allowed the method of computing the tax, and consequently the title given to it, to confuse them in their treatment of it in the accounts. It is a cost of doing business, and for the individual who pays income tax, it is part of the cost of living. They even taught us to mispronounce the phrase describing the tax. We accountants say income′ tax, whereas it should be income tax′. That collegiate dictionary they use at Ohio State University says that the word, "income," is a noun; however, in its secondary role as an adjective, it has done an effective job of modifying the noun, "tax," to the extent that you frequently hear one or two adjectives placed ahead of "income" to further modify the word, "tax." Several important companies have adopted annual report statements that depart from the customarily used accounting terminology. You will note that in nearly every such case a more basic change is to consider federal income tax as a cost of doing business.

I asked one of my colleagues to secure for me the 1949 Annual Reports of companies who had gone the furthest toward using the modern terminology. He gave me 17 of them, and of this group, 13 show federal income tax as a cost item. Among them are General Motors, U. S. Steel, Caterpillar Tractor, Firestone Tire and Rubber, Chrysler Corporation, Pittsburgh Plate Glass, Bethlehem Steel Corporation, and Westinghouse Electric Corporation. I advocate this practice, although not with the thought or desire of having it allowed as part of the cost of government contracts. The only purpose is to portray the facts more reliably.

Treating federal income tax as cost does not necessarily affect the treatment it should receive in the elimination of intercompany profit from the inventory value; this leads me to the next question. When we advocate elimination of intercompany profit in inventory, do we desire to eliminate period expense of the supplier company from inventory of the customer company? By "period expense," I mean expense and costs properly charged to operations as incurred as opposed to expense and costs temporarily deferred in the inventory until the goods are sold. Most of what I have read on the subject seems to be manifestly silent on the matter of resolving that question. The third edition of the *Accountants Handbook* is the first source to mention selling costs in this connection, maintaining that they are not likely to be quantitatively significant with intercompany transactions and stating further that although there can be no fundamental objection to showing consolidated inventories net of intercompany markups, the amount to be eliminated is the element of net income (before or after tax is not indicated), not gross markup over assigned production cost. Dollar-wise, I think the item is more significant than profit. It may include such things as federal excise tax, state and local income tax, sales and mercantile taxes, cash discount allowed, allowances for defectives, cost of field repairs, advertising by the supplier company, other selling costs, administrative costs, fixed factory expenses, and federal income tax if it is a cost or if the answer to question one is income *before* tax. I advocate elimination of all period costs of the supplier company from the inventory of the customer company. My strongest and most authoritative support for such a position is the belief that industry's practice leans rather strongly in that direction. Since I have found no written opposition to my vote other than the *Accountants Handbook*, and it wavers on the decision, I do not anticipate much controversy on it at this meeting unless it comes from the minority group of companies who do not follow the practice I recommend.

This reminds me of a recent proposal to the House of Representatives by one of the western state congressmen to the effect that accounting practices be prescribed by law and all business be required to follow such practices. Such a law might aid the realization of more uniform practices within the different divisions of the company. Certainly, uniformity of accounting practice throughout the subsidiaries and divisions is vital to reliable consolidated statements. The area in which lack of uniformity has the greatest effect on comparative operating results throughout industry is in the definition of period costs, i.e., those costs charged to operations as they are expended, as opposed to those costs which are charged to inventory or otherwise deferred or accrued. While I am reasonably well satisfied with the result of our corporation's effort along this line, I am convinced that the accounting profession needs to do some serious thinking for each of the major segments of business and industry and then instigate training along the line of defining period costs.

In discussing consolidations, everyone mentions the importance of first reconciling the current accounts among the corporations and the necessity of eliminating differences by transfer to the proper account. This step is necessary, of course, but the routine should be such that the current account is reconciled at all times. Twenty-five years ago, we advocated mailing invoices from one division of the company to another or from one of our companies to another and booking them at sending and receiving points much as we now do with our customer or supplier transactions. We now require each location to list or face sheet daily their sales to each other location. We have gone even further and established a clearing house for interunit transactions at headquarters so that branches do not need to keep a current account with each other. Instead, each branch has only one current account filed with headquarters and a copy of the summary of the daily face sheets which carries forward the total for the month to date and controls the account; in fact, it is the account for the month both at headquarters and in each branch. Corrections of bills and miscellaneous transactions are entered on the same face sheets with other transactions. With few exceptions, the bills are mailed through headquarters and are attached to the face sheets.

All the advantages of this procedure may not be apparent until it is studied or tried. In our case, it reduces the number of current accounts to about $\frac{1}{15}$ of the number that would otherwise be required. It permits a control at headquarters of the billing performance of the plants and other branches, which results in simplified standardized practices including control of pricing methods. It places all bills into the interunit billing routine so that all of it is mechanical and subject to control at headquarters as to scheduling and timing. This was a major advantage when the procedure was installed.

In the case of subsidiaries, cash settlements are made for totals periodically to approximate the date of payments in line with terms of the invoice; corrections are handled in reverse through the same face sheet procedure, eliminating formal detailed accounts receivable. This represents a major saving in connection with our distributing subsidiaries. We now have agreements with some independent distributing agencies for handling our receivables in the same manner, which works to a mutual advantage. If any of you send numerous bills to Westinghouse or receive numerous bills from us, we will welcome an opportunity to discuss the benefits of such an arrangement.

Federal income tax regulations, the Robinson-Patman Act, and other laws more than influence the price—they come near to *controlling* the price for transactions between the parent and subsidiaries. For this, if for no other reason, our price to distributing subsidiaries is the same as to independent distributors, the going or market price for the product. The price is subject to change with or without notice, and price protection on the stock of the subsidiary is maintained in line with the practice for the product. A reserve is established for the difference between the price to the subsidiary and the inventory value in the producing division. Since this reserve is not allowed as a deduction from income for the purpose of computing tax, the tax is deducted from an income which does not exist and the income is reported later with no tax against it. This tax advance, if I may call it that, to my knowledge, charged off by all companies as it is accrued, which is the conservative and, I believe, the proper way to handle it. What I have just said about distributing subsidiaries applies also to manufacturing subsidiaries except for the fact that most of the transactions between manufacturing subsidiaries are for materials, parts, and products which are not sold to other outside companies in the same form.

Westinghouse Radio Stations, Incorporated, is included in our consolidation. Although the operation of a group of radio stations is a different type of business compared to the manufacture and distribution of electrical products, there are sound reasons for making the consolidation in our case. Although it is not a significant part of the total, the Radio Stations' activity has grown for 30 years somewhat as has the electrical manufacturing business from its former position as part of the parent company.

We have now arrived at the point of discussing accounting for transactions between manufacturing divisions of the parent company. There are many such transactions in our case and their volume in dollars represents about 15 per cent of the consolidated production of the corporation and subsidiaries in terms of total cost. Some of the items are gray iron, aluminum and brass castings, molded parts, micarta, porcelain parts, copper wire, meters, small transformers, small motors, etc.

This interunit business presents problems for the management as well as for the accountant. The accounting plan we now follow has been in operation in essentially its present form for about ten years. There has been some criticism of the plan, and at one time during this period, a committee was appointed with instructions to study the problem and either develop a new plan for consideration by the division managers as a group, or confirm the plan then in use. A new plan was developed by the committee but was never adopted, because it lost out after discussion and vote by the division managers; the plan in operation was continued. After discussing the plan we use, I will describe briefly the plan proposed in the belief that an insight into these plans is helpful toward a better understanding of the problems involved in interunit transactions.

The interunit accounting practices in operation are generally uniform, particularly for valuing transfers between manufacturing units of the company and for determining operating results, i.e., cost and profit or loss, by the product lines sold to outside customers.

The plan contemplates:

1. No profit booked on deliveries from one plant to another although memorandum profit statements are made for such deliveries.
2. Valuing of interunit deliveries at standard works delivery cost with monthly charges for applicable expenses either as fixed amounts for a period, amounts for a specific expenditure, or as a percentage of standard cost billed for the month. These amounts above the standard works delivery cost applied to deliveries and some other items of direct cost are charged to current operations by the receiving location.

NOTE: If it is known that the plan for pricing may work a hardship or create a problem at a particular plant location, this is recognized, and responsibility and authority is placed in the hands of the controller to alleviate the hardship without materially changing the policy involved.

3. Profit and loss statements by lines of product which will include the total billing and the total cost of sales.
4. Division or plant statements showing profit or loss on sales exclusive of interunit deliveries.
5. Division or plant profit or loss statements for interunit production. These interunit products share in the billing price of the completed product on the basis of the relationship of costs of the interunit product to total cost of the product sold to the outside customer. These are memorandum statements built from the costs transferred and from the official billing figures of the customer divisions.

This plan is used between plants and also between departments within a plant when separate factory expense, inventory, and product profit or loss statements are maintained.

Where competitive pricing of parts or apparatus from outside suppliers is lower than standard cost plus the amount for period expense, the policy is to *make* the product rather than to buy it if the total of direct labor, direct material, and variable overhead is equal to or less than the outside supplier price. If the result is a low profit or loss for a line of product, that fact is indicated by note on the profit and loss statement. This point is more theoretical than real, because such a situation seldom exists, and if it develops, something is done to correct it.

As was previously stated, the total standard cost value of the current month shipments to each customer division is accumulated and the amount of period costs applicable thereto is computed and billed on one debit each month to each customer division to which shipments were made. Such debits contain a record of standard works delivery cost and period cost added thereto in such detail as to permit analysis of the bill and to permit segregation of the product on which the interunit deliveries will be used.

Managers of accounting of each supplier division develop and recommend methods, rates, and revisions of methods and rates for applying period cost to standard works delivery cost. The intent is to include actual costs as they will be incurred, based on current conditions modified if necessary to be consistent with forecasts. These division managers of accounting submit such proposed methods and rates to the director of inventory and cost accounting. They are not made effective until he has approved them. Methods and rates are reviewed at six month intervals and revisions are usually effective April 1 and October 1; however, when conditions are stabilized, the semiannual review often indicates that revision is not necessary. The number of different methods or rates is contingent upon what is necessary to obtain reasonable accuracy. The determination of the number of such methods and rates required presents a problem similar to the one of establishing cost centers incident to installation of standard cost.

The objective is to develop the actual cost of the product and to transfer such costs from the producing division to the receiving division in the month delivery is made while at the same time valuing the inventory at the correct level exclusive of period costs. No profit is billed.

What I have said may be an oversimplified explanation of the procedure we currently follow; however, I meant to infer that it was not quite as simple as the pricing of each shipment at standard works delivery cost plus a monthly billing for period expenses computed as a percentage of standard works delivery cost. Obviously, the period expenses applicable to a piece of steel from a storeroom would not be as great as those pertaining to fabricated micarta, and likewise, the period expenses applicable to the latter would not be as great as those relevant to a transformer in terms of a percentage of standard works delivery cost. If the transformer should happen to be a very special one, there would be an item of order development which would be accumulated on a job cost basis and included as an item of the price on the shipping notice. There are quite a few such complications, but they do not apply to the great volume of shipments.

From the above, I hope it is clear how we prepare a memorandum operating statement for interunit transactions. More particularly, it is vital that you understand that the interunit accounting procedure provides identically the same operating statement for the product that would be possible if the product were manufactured in its entirety in one and the same division.

I would like to mention a situation which some of you may consider as an interunit problem, but which I think is outside of the realm of the problem I have been discussing.

The company frequently receives an order for two or more products which are manufactured and shipped to the customer from two or more divisions. In such cases, the total price is made up of the individual prices for each of the products, and the policy is to allow each division to receive the billing credit for the price of the product it ships. In some instances, a division will ship its product to the customer by way of another division which is shipping on the same customer's order, in which event the billing credit is similarly split between the two divisions so long as the product does not lose its identity in the equipment supplied to the customer. A manufacturing division may waive these billing credit rights and transfer cost and follow the interunit plan described if:

1. Production consists of parts, assemblies, or details which are in salable form only as renewal parts or accessories.
2. Production consists of meters, instrument transformers, standard control apparatus, small motors, etc., where manufacturing time, number of orders, and amounts involved per item or number of items will require excessive checking to clear the accounts.

In some instances, an order calling for a product shipped from two or more divisions has to be invoiced to the customer from one location and cannot always be invoiced at the time of shipment. The cost is, therefore, carried in the inventory of the producing division until the order can be invoiced in line with the terms of the contract; at that time, the billing credit is transferred to the division which shipped earlier, and billing and cost is then entered on the operating statement.

I mentioned earlier that a committee appointed to study the subject recommended another interunit plan which was not adopted. The plan provided for each division to sell its products to other divisions on a negotiated or market price basis. The idea is a very natural one and has considerable merit. We might price interunit shipments at the negotiated or market price although such prices have no relationship to standard works delivery cost; however, we could then price the shipments at standard works delivery cost, also. We could consider the difference between the two prices to be period expense in the receiving division, charge the standard works delivery cost to the inventory account, and charge the difference, which, in reality, is period expense and profit, to operations currently in the customer division. This method would very reliably remove profit and period expense from the inventory, but it would cause the operating profit of the customer division to fluctuate out of step with sales when incoming shipments were out of step with sales. This fluctuation could be much greater than is the case with our present practice, due to the fact that this item of period expense would include profit.

Another way of handling the accounting for this plan would be to show the negotiated or market price on the shipping notice and enter this amount into the inventory of the receiving division. Then it would be necessary to set up an inventory valuation reserve to eliminate the approximate period expense and profit included in it. This reserve could be in the customer division accounts or on headquarters accounts only; it would be extremely difficult to determine reliably the proper amount for this reserve. This method would have the questionable advantage of spreading period costs and profit over the sales billed on the customer division's operating statement. Under neither of these accounting procedures would we have the actual cost to produce the product sold; an element of profit would always be included. Following the first procedure, this element of profit would be limited to the period expense figure accumulated and, therefore, could be more closely determined both by divisions and by product lines. Also, operating statements of the supplier division would include an unrealized profit. This profit could be determined by separating interunit sales and cost from the sales and cost for orders from outside customers.

The advantages to be claimed for our present plan when compared to the one proposed by the committee are:

To the Supplier Division

1. Simplifies handling of interunit transactions by encouraging use of standard forms for orders, shipments, and bills.
2. Automatically separates interunit business from customer business and permits preparation of separate operating statements for each. This is important because sales, advertising, and other expenses do not apply to both to the same extent.
3. Avoids cash discount, prepaid transportation, and other folderol often resorted to on commercial transactions.
4. Eliminates effort of establishing satisfactory negotiated prices.

To the Customer Division

1. Provides true company profit figures for product lines sold to customers.
2. Maintains inventory values and costs on basis of standard works delivery cost without interdivision profit or period expense being included.

To Management

1. Provides management with a better answer to the "make or buy" question.
2. Shares the responsibility for equipment investment in the supplier division with the customer division.

The more important advantages to be claimed for the plan prepared by the committee are:

To the Supplier Division

1. Permits a division to conduct its customer and interunit operations with one and the same quotation, order, and invoice procedure.
2. Provides a greater incentive in some instances for divisions to undertake interunit work.

To the Customer Division

1. Provides greater price stability.
2. Relieves suffering from the high cost of the supplier division. The more important angle of this point is that the plan proposed by the committee avoids the "cost-plus" idea which exists in the plan we are using at present. This idea is no better for interunit business within a company than it is for government business, and under our present plan, we use every means at our command to avoid cost-plus thinking.

A knowledge of the history of a supplier division and of its interunit business is necessary in order to understand which plan the manager of that division is likely to prefer. If it is a division established for the purpose of producing an interunit product for a number of divisions, for example, our foundries, or if it sells few or no products directly to outside customers, as is the case with our foundries, our present plan will probably be favored. On the other hand, if the division "made its place in the sun" first by selling its product to outside customers and then learned that its product could be sold to another division of the company, it will no doubt prefer the quoted or market price basis.

If the customer division is in the habit of buying large quantities of pieces on the outside and also acquires similar pieces from another division of the corporation, it is likely to prefer to buy interunit products at a market price even when the price might be lower under the present plan. If a customer division buys only raw material and fabricates most of its product but desires to sublet some fabrication work or buy a casting from another division, it will favor our present plan, because in such cases the supplier division must play safe in setting a price and a comparison with another supplier's price may not always justify the effort, item by item.

I have touched on only a few of the considerations associated with the procedures discussed and have overlooked almost entirely many considerations for determining when to "make or buy," such as delivery date, quality, anticipated redesign, and facilities and inventory available within the corporation.

Chairman Clarke: Our next speaker, Mr. Logan Monroe, tells me that he obtained most of his accounting education through the hard school of practical experience.

Experienced as a cost accountant, factory accountant, purchasing agent, treasurer, and controller, Mr. Monroe is singularly well-equipped to serve as president of the National Association of Cost Accountants and Controller of Eaton Manufacturing Company. The subject of his speech today is "Cost Control and Cost Reduction—The Fundamental Responsibility of the Industrial Accountant."

Mr. Monroe.

COST CONTROL AND COST REDUCTION—THE FUNDAMENTAL RESPONSIBILITY OF THE INDUSTRIAL ACCOUNTANT

By Logan Monroe
President, The National Association of Cost Accountants; Eaton Manufacturing Company, Cleveland, Ohio

I am going to start out by using an old shopworn cliche and tell you that I am very happy to be here. However, I feel that I have more than the usual and obvious reasons for making that statement.

First, it has been my pleasure to have attended all but two or three sessions of the University's Institute on Accounting, and during that time I have formed an ever-increasing interest in its proceedings.

For the second reason, I must reminisce for a moment. In 1944 during the war period, when men like Jake Taylor, Hermann Miller, and scores of others were in uniform, Russ Willcox dipped down into the bottom of the barrel and came up with me as a speaker. I shared the platform that day with Vic Stempf who at that time was President of the American Institute of Accountants. We had a common subject, "Nature of Post War Accounting," he taking it from the viewpoint of the public accountant and I from the viewpoint of the industrial accountant. My talk today is actually a sequel and an outgrowth of that talk I made here six years ago, so I am quite naturally pleased to have another thirty or forty minutes to belabor the subject.

Although I took more than thirty minutes to say it back in 1944, my entire paper boiled down to the theme sentence which stated, "the most important responsibility of the industrial accountant as a part of management is to control costs, which means to reduce them."

Now that statement probably appears somewhat dogmatic to many accountants. I note that Mr. Carr is speaking this evening on "The Function of Accounting in Modern Management," and it is quite possible that he will convince you that there are a number of things more important to the accountant than the reduction of costs. However, during the more than 35 years that I have been engaged in the industrial accounting field, I have become more and more convinced that the industrial accountant can do more for himself personally and more for the economy in general if he will stress this phase of his functions and responsibilities to the subordination of others. On the other hand, I would be the last to imply that this is the only responsibility and function of the industrial accountant. I just think that it is the most important one.

In expounding that opinion and philosophy before groups of accountants, I have found that I could obtain at least more interest, if not more converts, by approaching it from the case method standpoint rather than by placing emphasis on theory and philosophy. For that reason, I am going to try to tell you some of the things that have been done over the years in my own company toward reducing costs, confining myself to those cases in which the accounting department has either initiated the action or has occupied a key position in its accomplishment.

In talking today about those things which we have done in our company, I shall, of necessity, have to speak to a great extent in the first person. I cannot stress too strongly that it is done in no sense of boasting or chest thumping but more in a sense of humility. We did it because we had to. I shall also confess at the start that I am going to tell you only those things we did successfully. It would take me far longer to tell you about the other times when we stubbed our toes or fell flat on our faces.

I believe that it would be helpful to first give you a brief picture of our company, its products, and its organization. Our company was born 39 years ago in Newark, N. J. The year of our birth, 1911, preceded political corporate birth control. In those days, it was quite respectable to start a business to make a profit. And in spite of the philosophy that has been preached in the last eighteen years, our prime purpose is still to make a profit. Today, we have fourteen (14) plants in ten cities, employing 9,000 people. Our plants are of moderate size, varying from a minimum of 150 employees to a maximum of 2,000. Our principal products are automotive and aircraft parts. With the exception of two small wholly-owned subsidiaries, we are one corporation made up of ten operating divisions. Financial and accounting control and matters of broad policy are the only exceptions to the fact that each division is a decentralized operating unit under the supervision of a division manager who usually holds the rank of vice president. Each division has a resident controller who is charged with a divided responsibility, a practice which is contrary to all principles of good organization, but which in our case seems to work. On financial and accounting matters, these controllers are responsible to the General Office in Cleveland. On matters of internal cost control, they are responsible primarily to the division manager. These divisional controllers are supposed to be, and usually are, the right-hand men of their respective division managers, and together, those two make a team which we consider ideal for cost control.

The general ledger for each division is maintained in our General Offices and all journal entries based on manufacturing operations are made at the plant and forwarded to the General Office. Each division has its own *chart of accounts*, which is similar but not identical to the *charts* of other divisions. We do not have a uniform cost system. We do have standard costs in all plants, but each system is tailored to best suit the particular needs of the plant. Most of our controllers came up through the ranks. They can and do talk shop language, and on occasions, with all the trimmings!

I shall confine my remarks to manufacturing costs, as our selling and distribution costs are negligible by comparison. Selling as we do to the automotive and aircraft manufacturers predominantly, we naturally have few customers. Generally speaking, one or two sales engineers suffice for each plant and about all we in accounting can do with respect to their cost is to make sure that they do not bury too many of the proverbial suits of clothes in their traveling expense reports.

As a rule, our manufacturing costs are divided in the conventional manner into three main segments—material, labor, and overhead. I shall discuss them in that order.

The quantity and quality of the material entering into our product is, in the main, outside the province of our accounting departments. Most of our products are jointly designed by our engineering department and those of our customers. Under the highly competitive conditions of the automotive industry, these engineers and designers are themselves quite cost conscious. In this respect they are greatly aided and abetted by the purchasing departments of our customers. The material component of parts manufactured by us is susceptible to minute cost analysis by the buyer, and I say with all sincerity and respect that the automotive purchasing agent as a class is one of the greatest and most efficient forces for cost reduction that you will ever encounter. By the time our cost accountants enter the picture, the material element has been resolved so far as cost reduction is concerned.

There remain, however, several avenues of attack by virtue of our accounting techniques and reporting. Perhaps our most successful efforts have been in the line of inventory control. We probably employ most of the conventional devices, but there are two which might be of interest. At the end of each month, we furnish every individual concerned with inventory control—from the president down—with an analysis of each plant's inventory balances, broken down into as many components as our *charts of accounts* permit, covering each of the last six months. Opposite every component for each month we show ending inventory and the usage of that item, followed by a ratio indicating the number of months' inventory on hand, arrived at by dividing inventory by usage. This is a simple report but very revealing and productive of results.

The second device is really a part of our flexible budget procedure about which I shall have a great deal more to say later. But this particular procedure affects material and I shall describe it here. Four times each month every division controller writes, in letter form, to the president of the company (a copy being sent to his division manager), stating the indicated net change which will occur in his division's inventories for the current month. The increases or decreases are broken down into the main components of material, labor, overhead in process, and supplies, and a brief explanation is submitted dealing with the causes.

I might state that this rather unorthodox line of reporting, from division controller directly to the chief executive of the company, was initiated at the express request of the president himself and, believe me, he *uses* these reports. Our goal is to turn our inventories monthly, which we have done on occasion, but as an average we have been able to turn them only eight to ten times a year.

There is another manner in which the accounting department is uniquely qualified to indirectly control and reduce material costs; that is, to inform management, through cost analysis, whether it is better to buy or to make. I shall not delve into all of the ramifications of this. However, it is not simple! I believe this function requires as broad a viewpoint and as much experience as anything which the industrial accountant is called upon to do. It is very easy to make the mistake of thinking that this is purely a matter of mathematics, but any accountant who tries to work out some of these situations with the aid of only a textbook and slide rule is going to come up some day with a very red face. You have to know all the causes and effects in the particular plant and industry in order to accomplish this job correctly.

Using standard costs, we keep track of all material variances and furnish management with detailed analyses of the amounts and causes; however, we do not claim anything startlingly different from what the great majority of you are undoubtedly now doing.

Scrap is another important element of material costs, but I shall cover that in more detail under the heading of overhead, of which scrap is considered a part.

I admit that the accounting department necessarily runs second to the engineering and purchasing departments. We accountants do have some influence over this element of cost, but it is more a function and responsibility of those other two departments.

When we consider the control and reduction of labor costs, the influence of the industrial accountant increases. I shall first discuss direct labor costs and leave that more elusive element, indirect labor, to my remarks about overhead. We pay for direct labor on two bases—piece rate and hourly or day rate. Four of our fourteen plants pay productive workers on a piecework basis and the other ten plants effect remuneration on an hourly-rate basis.

Under a piecework system, the greater portion of our control centers in the time and motion study and methods departments. But we, in the accounting department, do play a part. There is a tendency to assume that under a piecework system, maximum productivity is always attained. We know that that is not true, and for that reason, we report efficiency of pieceworkers by departments and in some cases by individuals. Under our piecework system, rates are set to enable the average employee to earn a predetermined hourly rate. These rates are established for the various job classifications by negotiation between union and management and are known to us as "base rates." In reporting efficiencies, for the most part, we have proceeded only to the point of establishing weighted, average base rates for each department; we divide total base-rate earnings into total piecework earnings in order to obtain the percentage of efficiency for the department as a whole.

Frankly, we have not had enough experience with this procedure to determine what we will derive from it. However, our figures were very useful some time ago when, as part of a strike settlement, the union won a concession on the premise that pieceworkers would increase our productivity. When the men returned to work, our figures indicated that this part of the agreement had not been complied with. The union committee was called in, shown the record, and was subsequently instrumental in increasing our productivity by about 5 per cent.

Because of the lack of incentive, the problem of obtaining maximum production under an hourly-rate system is considerably more difficult than under piecework. At the hourly-rated plants, as at the piecework plants, we have time and motion study departments which establish standards of production. We also establish hourly rates by job classification in the same manner as base rates are arrived at under the piecework plan. There is an important difference, however, between our plan and the usual system. Our union agreements provide that, if an operator's performance falls below standard by a certain amount (usually 5 per cent) for a given period (ordinarily three weeks), his rate is reduced. And if his performance declines still further, he may receive another cut, be reclassified or, in extreme cases, be discharged.

To administer the union contract, it is necessary to compute the efficiency of each productive employee. Even if there were no union contract, we would still be vitally interested in individual productivity. It is possible for individual employees or entire groups to fall below standard without incurring a penalty. For this reason, each employee's efficiency is calculated daily, and employees falling below standard are reported to the foreman. Of course, this deficiency is by no means always the fault of the employee. There are other causes, such as poor material, shortages of material, tool and machine trouble, etc. Regardless of where the fault lies, when the employee's low efficiency is reported the following day, the cause is brought to light and corrective action taken if possible. We also report departmental efficiencies to foremen and management.

With standard costs, we have an additional control on direct labor through the analysis and reporting of variances. However, we treat direct labor variance as an overhead item and, as such, it will be further discussed later.

From what I have said about control and reduction of direct labor costs, you can see that the most important responsibility for this rests upon the time and motion study and methods departments. However, since all labor reporting and most analysis is done by the accounting department, our influence here is more important than I could demonstrate with respect to material costs.

Now we come to that segment of cost in which the industrial accountant, if he is doing his job, is truly the controller. I refer to overhead or manufacturing expense. The only good thing that I can think of about overhead is that it gives us industrial accountants a fine field in which to show that it can be controlled and reduced.

Our flexible budget with its ramifications is perhaps our most potent weapon in our fight with overhead. I think that perhaps the simplest way in which to show you how our flexible budget works would be for me to explain its evolution. It should be interesting to note that every step we took leading up to our present fairly complete budget system was taken primarily to reduce costs in some respect. We did not have a grandiose idea of a budget system when we started out—all we were trying to do was to cut costs.

One of the very first things we tackled was indirect labor. Direct labor was already satisfactorily under the control of the standards department but indirect was like the weather—everybody talked about it and you know the rest.

The first and simplest device we used is something which I believe should be adopted by every cost accountant, and it can be furnished to management with practically no red tape—a daily attendance report. Way back in the '20-'21 depression, we were forced to go the limit in reducing expenses and keeping them reduced. The payroll, being the largest variable among our expenses, was given the most attention.

Each morning as soon as possible we laid a mimeographed form on the plant manager's desk showing the number of men who had started to work that morning. This was simply a recap taken from the "In and Out" clock cards. On the left upper half of the sheet, we grouped all of the so-called productive departments showing the number of men in each department, with a total for all productive departments. We did the same thing on the left lower half of the sheet for the nonproductive departments showing the number of men in each department and the total for these departments; at the bottom of the sheet, we showed the grand total of all men working. In a short time, the manager had fixed in his mind what the ratio of these two subtotals should be—that is, productive to nonproductive.

Later, we made this report cumulative and had columns for all days of the week on the same sheet of paper. This is how is worked. If on Wednesday, the productive total dropped 50 men as compared with Monday and Tuesday and the nonproductive did not show a proportionate drop, our plant manager would run down the list of nonproductive departments and make notations opposite each one, indicating how many men there should be; that became the attendance report for Thursday.

That sounds very simple, and it was, but it worked. These attendance reports have been amplified somewhat in recent years, principally to reflect the nonproductive employees working in the productive departments, but they are still essentially as I have just described them. To me they seem to bring larger returns in proportion to the effort expended than any of our other various reports. They are still one of my favorites.

Even before the use of attendance reports, we gave our managers daily figures on total productive and nonproductive labor in dollars. These also were shown by departments and as totals. However, they were always one day late and sometimes more. That delay was eliminated by means of the attendance report. In our efforts to control and reduce indirect labor we began to realize that the key men in accomplishing these results were our foremen. We realized more: this same truth applied to practically all variable expenses. When we pointed this out to management, we were given an approving pat on the back, but when we went a step further and said that foremen should be told the amount of these expenses in dollars, we did not receive such enthusiastic endorsement.

Up to that time, management had followed the policy of telling our foremen as little as possible of a cost or financial nature. We gave them various production figures, ratios, etc., but we never tied these up with the impressive, but very confidential, dollar sign. Finally, our management agreed to try an experiment along this line by showing our foremen the cost of the scrap made in their respective departments, scrap being quite excessive at that time. Our hesitancy in showing these costs to our foremen may sound rather exaggerated, but at that time it represented a rather radical step; it just was not being done.

The first report with dollars on it that was made available to our foremen was quite simple. It merely showed the total cost of scrap by departments and was issued monthly. All departments were shown on one sheet of paper so that each foreman could see how his total scrap compared with the total scrap of other departments. This simple little report produced some amazing results. We found that each foreman took a great deal of pride in the comparative performance of his department and our scrap losses in a few months were halved; remember, of course, that they were excessive at the outset.

When we saw what good results had been obtained by the scrap report, we wondered why we could not go further and give each foreman a similar report of all expenses that were directly under his control. We put that idea across without much trouble and began furnishing each foreman with a monthly report showing his controllable expenses compared with all of the previous months of that year. Opposite each monthly total we showed the direct labor, which was still our best measure of production; (at that time all of our plants were using piecework). We did not show him the figures of other departments, however, as we had done with scrap. At first these reports resulted in some appreciable reductions, also, but after a certain time, we began to feel that these reports were getting in the same class with most reports. They were duly received and duly filed.

Then it occurred to some of us cost accountants that the control of these expenses could be put on an incentive basis, paying the foremen in proportion to reductions which they could effect—in other words, a *foremen's bonus plan.*

It took a long time for management to become accustomed to that idea. However, about that time, some industrial engineering firms began to advertise their success along these lines, and we were finally given the yellow caution light to go ahead. Fortunately for us we did not try to be too scientific; I am afraid that if we had, we would have swamped ourselves and the bonus plan along with us. We already had the controllable expenses tabulated by departments over a period of several years as well as the direct labor for these departments, and we had been presenting these two comparative figures to our foremen for some time. It was fairly logical to base our original bonus plan on these data.

The first step was to establish a standard for each department. We did this by using the same data which we had been giving the foremen monthly for a year or more, that is, controllable expenses versus direct labor. From these two sets of figures, we calculated ratios for each month and for the year's total, and from a study of these ratios, we established a standard for each department. When the foreman's current expense ratio was reduced to this standard, or lower, he received a bonus.

That is a slight oversimplification of our actions, but, essentially, that was about all there was to it; however, in calculating the bonus earned, we used a moving average covering a period of three months, the current month and the two preceding ones. This was to discourage any manipulation of expenses by the foremen; from their viewpoint, it gave them credit over a three month period for an exceptionally good month and did not penalize them too long for an especially bad month.

The nonproductive or indirect departmental foremen also had a bonus established for them on the same basis except that the direct labor used was that of all the productive departments serviced by them or whose production affected their expenses.

That was our first attempt at a foremen's bonus. We started this plan just twenty-three years ago in two of our Cleveland factories, and in spite of its obvious defects which we can plainly see now, it worked astonishingly well. However, some of the faults in the plan had to be corrected very shortly. We rectified the first one at the request of the foremen themselves. They did not want to wait until the middle of the following month to learn how they had made out, but instead wished to know their standing every day. This was not as big a problem as it might seem. Controllable expenses came from only a few sources—the payroll, supply stores requisitions, scrap reports, and accounts payable items charged directly to expense. We were already distributing payroll daily. Our supply requisitions up to that time had been priced several times during the month, which was also true of our scrap reports. Our accounts payable items had been passed through as invoices were rendered. In view of the fact that the accumulation of these data daily involved little additional work, we changed to daily reports.

We designed a simple form listing the major items of expense. Each day, the foreman was given this form showing his expenses for the preceding day and the accumulative total for the month. His direct labor, daily and to-date, was displayed below this total as well as the to-date ratio which indicated to the foreman what his bonus would be if he maintained this ratio.

Another major defect was the practice of basing each foreman's budgeted expenses on direct labor dollars. Further study determined the unit which best measured the controllable expenses of each department, such as direct labor hours, machine hours, furnace hours, units of product produced, area plated, tonnage, etc., and these units were substituted for the former criterion. However, it would probably surprise the perfectionists to learn how well direct labor worked, remembering, of course, that all direct labor dollars were piecework.

A further improvement was made by departmentalizing each plant to a greater extent in order to better reflect each foreman's area of authority and responsibility. We also broke down our expenses into finer classifications and established a budgeted standard for each item rather than the one all-inclusive allowance originally set up. This facilitated adjustments in budgeted allowances when methods or products were changed.

We did not hesitate to adjust standard allowances, either temporarily or permanently, when we saw that the original or present rate was wrong. However, we were very careful to make sure that it *was* wrong before we adjusted it and then it was done only with approval of the plant manager.

I have purposely used a large portion of my allotted time this afternoon in telling you the high spots of our foremen's bonus plan, because it is the most important device we use in controlling and reducing overhead. It is a tool designed and operated by the accounting staff in a field where the industrial accountant is peculiarly well qualified to operate. Material costs are primarily the responsibility of well-qualified engineering and purchasing staffs. Direct labor is usually well controlled by time and motion study and methods departments, but those thousands of elusive things included under overhead can best be controlled by the industrial accountant. In my opinion, the industrial accountant who does not take the lead in controlling overhead is missing the biggest opportunity of his job.

In discussing our foremen's bonus plan, I have used the words, "budgets" and "standards," almost as often as I referred to foremen's bonus—they are the same. The foremen's bonus plan is our flexible budget for overhead. And with standards established for every item of cost, that is, material, labor, and overhead, you have all you need for a complete budget system by adding a comparatively small amount of almost routine procedures.

I should now like to tell you briefly how all of the elements of our budget system are condensed and presented to management. At the latter part of each year, we make up a sales forecast for the following year. It is really only an intelligent guess, because the automobile industry is subject to so many economic and human forces that about all we can do in preparing a long-range forecast is to follow the estimates of our customers who are far better prepared than we are to judge the future demand for their product. This annual forecast serves as a guide for long-range policy decision.

Our actual operating budgets are made up for a much shorter span, first, on a month-to-month basis—then on a week-to-week basis. They are controlled almost entirely by our customers' shipping releases. This work is done under the supervision of our divisional controllers as follows:

On the second of the month, each controller sends to Cleveland the sales budget for the current month. These divisional budgets are consolidated and are handed to the top management of the company; this refers to budgeted sales only.

On the seventh of the month, each controller forwards to Cleveland for the current month a complete budgeted *profit and loss statement* for his division, together with a condensed manufacturing expense statement, breaking down these expenses into 25 to 30 of the more important classifications and also reflecting the budgeted burden absorbed together with budgeted burden variance. At the same time, he sends a letter to the president showing the net change to be expected in inventories.

The condensed manufacturing expense statements for each plant go directly to the president and to the general vice president in charge of manufacturing. The plant *profit and loss statements* are consolidated in the general accounting department and passed on in consolidated form to the president and to three general vice presidents on two sheets of paper similar to these which I am holding in my hand. One shows sales by divisions with grand total and the other, profit and loss by division with grand total.

On the 15th of the month, this entire operation is repeated, resulting in adding another and revised column on these small sheets, on the plant *profit and loss statements*, and on the plant manufacturing expense statements. Any changes of importance are explained briefly in memo form.

On the 22nd of the month, this operation is repeated, and finally on the last day of the month a final revision is sent in. So, by the 1st or 2nd of the following month, top management has these sheets plus the supporting statements, all of which contain five columns—"Last Month Actual," "Current Month Original Budget," "15th," "22nd," and "Final Revisions."

At first, this may seem like a great deal of detail, but the clerical work is routine and for the most part merely reflects accumulative totals of accounting details as they are built up during the month, plus anticipated changes in production schedules and operating variances.

If you are not engaged in the automotive parts business, you are probably wondering by now why we go through all of these seemingly repetitive operations. There is a good reason for our actions. The automotive parts manufacturer is subject to numerous and violent changes in his production program and he cannot set up long-range budgets such as Procter and Gamble or National Cash Register where the product is shipped in consumer form. This week, Ford might be shut down because of lack of steel; next week, General Motors might be idle because of labor trouble in its own plants; and the following week, Chrysler might be closed because of a strike in some of its supplier plants. Therefore, the poor parts manufacturer must of necessity budget almost from day to day.

I said earlier that we were a profit-minded company and in support of that statement, I want to say that these two sheets of paper get more attention and action by top management than all of the other statements we produce added together. When a division starts to slide off, everyone in authority from the president down knows it almost at once. What is more important, they know the *reason* for the decline and if it is in the power of any or all of them to do anything about it, they do it immediately.

Our reporting facilities have become accurate enough over the years to assure management that when they get the final revision on these two sheets, they can quit worrying about what we will show when we actually close the books, because the difference between the two is never enough to cause any concern. On the 1st of the month, management begins to worry about what is going to happen in that month just beginning. Last month is already "water over the dam."

Gentlemen, I have tried to tell you in thirty minutes what it has taken us thirty years to evolve. We claim no patent and perhaps very little originality, but in doing this, we have tried to practice what I preached at the beginning of my talk, that is, the most important responsibility of the industrial accountant as a part of management is to control costs—which means to reduce them.

FOURTH SESSION

FRIDAY, MAY 19, 1950—7:00 P.M.
Deshler-Wallick Hotel—Dinner

Presiding:

WALTER C. WEIDLER, *Dean, College of Commerce and Administration, The Ohio State University, Columbus*

Introductory Remarks:

SAMUEL BROAD, *Peat, Marwick, Mitchell & Company, New York City*

Presentation of Accountants Elected to The Accounting Hall of Fame

Letter from Mr. May

Paper: "The Function of Accounting in Modern Management"

WILLIAM HERBERT CARR, *President, The Controllers Institute of America, Inc.; California Packing Corporation, San Francisco*

INTRODUCTORY REMARKS

By Samuel J. Broad
Chairman of the Nominating Board for The Ohio State University Accounting Hall of Fame

Before proceeding to the more pleasurable part of the program I think it would be appropriate for me to say a few words about the genesis, the organization, and the procedures of the Accounting Hall of Fame.

The Ohio State University, and particularly the Department of Accounting with its usual flair for doing things early and doing them well, decided that it would be a good thing for the development of the art of accounting to initiate a Hall of Fame whereby honor could be extended to those who had made outstanding contributions in that field.

With this objective in mind, a Nominating Board was appointed consisting of 15 practicing accountants, 15 accountants engaged in industrial and governmental work, and 15 accounting educators. All of the practicing accountants have been active in professional circles and half of them are men who have served as president of the American Institute of Accountants. The accounting educators are prominent professors at important universities, most of whom have held office in the American Accounting Association. The industrial and governmental accountants have been equally outstanding in their respective fields. It is indeed an honor to have been elected chairman of such a group.

Each member of the Nominating Board was asked to nominate five persons, taking into account certain criteria, among which were the following:

1. Contribution to accounting literature.
2. Public speaking before professional and other groups.
3. Service to accounting organizations of a professional character.
4. Recognition as an authority in a particular field.
5. Public service.

The ten persons receiving the highest votes in nomination (with some weighting for the order of preference) were submitted in a second ballot; and the second ballot on these ten resulted in the election of those receiving the highest preferential ballot.

The effect of the weighting for order of preference this year could have made no difference in the final result. The three candidates selected would have been elected in any event.

The University and the Nominating Board are both very conscious of the fact that the honor bestowed through election to the Accounting Hall of Fame and the prestige of the Hall of Fame itself are dependent upon the care which is taken in selecting outstanding candidates. If the results of the election in this, the first year are any criterion, I am sure that you will agree with me that these objectives will be obtained.

EDITORIAL NOTE: Members of the Nominating Board selected to serve during the year 1950 and who accepted the appoints are:

Alabama—Tuscaloosa, S. Paul Garner, University of Alabama.

Canada—Toronto, Arthur E. Child, Canada Packers Limited.

California—Berkeley, Perry Mason, University of California; Stanford, J. High Jackson, Stanford University.

Illinois—Chicago, Willard J. Graham, University of Chicago; Christian E. Jarchow, International Harvester Company; Maurice H. Stans, Alexander Grant and Company; Edward B. Wilcox, Edward Gore and Company. Peoria, William Blackie, Caterpillar Tractor Company. Urbana, Hiram T. Scovill, University of Illinois.

Indiana—Indianapolis, Howard C. Greer, Kingan and Company; George S. Olive, George S. Olive and Company.

Iowa—Iowa City, Sidney G. Winter, University of Iowa.

Massachusetts—Boston, Thomas H. Sanders, Harvard University.

Michigan—Ann Arbor, William A. Paton, University of Michigan. Dearborn, Victor Z. Brink, Ford Motor Company. Detroit, George D. Bailey, Touche, Niven, Bailey and Smart.

Minnesota—Minneapolis, Ernest A. Heilman, University of Minnesota.

New York—New York City, Samuel J. Broad, Peat, Marwick, Mitchell and Company; Percival F. Brundage, Price, Waterhouse and Company; James L. Dohr, Columbia University; Paul K. Knight, Arthur Andersen Company; Edward A. Kracke, Haskins and Sells; John H. MacDonald, National Broadcasting Company; Arthur H. Rosenkampff, New York University; Walter L. Schaffer, Lybrand, Ross Brothers and Montgomery; Philip J. Warner, The Ronald Press Company; C. Oliver Wellington, Scovell, Wellington and Company.

Ohio—Cincinnati, Joel M. Bowlby, The Eagle-Picher Company; Kelly Y. Siddall, Procter and Gamble Company. Cleveland, Thomas M. Dickerson, Western Reserve University; Logan Monroe, Eaton Manufacturing Company. Cleveland Heights, Henry M. Kimpel, City of Cleveland Heights; Dayton, L. G. Battelle, Battelle and Battelle; Grant R. Lohnes, The National Cash Register Company.

Oklahoma—Oklahoma City, T. Dwight Williams, T. Dwight Williams and Company.

Pennsylvania—Erie, John H. DeVitt, Hammermill Paper Company. Philadelphia, John H. Zebley, Jr., Turner, Crook and Zebley.

Tennessee—Knoxville, Harvey G. Meyer, University of Tennessee.

Texas—College Station, Thomas Leland, Texas A and M College. Houston, Ernest C. Breeding, The Texas Company; J. R. Mulvey, Humble Oil and Refining Company.

Virginia—Richmond, T. Coleman Andrews, T. Coleman Andrews and Company.

Wisconsin—Madison, Fayette H. Elwell, University of Wisconsin.

CHAIRMAN BROAD: Mr. President: The Nominating Board of The Ohio State University Hall of Fame presents William Andrew Paton.

Professor Paton is a graduate of the University of Michigan with a Ph.D. in Economics. He has a long period of service as a professor at that University, with which he has been associated, except for brief intermissions, since 1914. He also holds the degree Doctor of Letters from Lehigh University.

An erudite but easy teacher, he passed inspiration on to students, which, like ripples from a stone cast into the water, has spread in ever-widening circles. Many of his former students are found in positions of high responsibility in academic, professional, and business fields.

Professor Paton was one of the early members of the "American Association of University Instructors in Accounting," later to become the "American Accounting Association"; he was president of the latter organization in 1922 and its research director from 1936 to 1939. He is the only member of the Committee on Accounting Procedure of the American Institute of Accountants who has served continuously since its establishment. His objective and clear-thinking approach to each question before this committee has commanded the utmost respect of his colleagues.

Numerous articles of his have appeared in the *Journal of Accountancy*, *The Accounting Review*, and elsewhere. A prolific author, his books, *Essentials of Accounting* and *Advanced Accounting*, in particular, are standard texts. With Professor A. C. Littleton, he write *Introduction to Concepts and Standards of Corporation Financial Statements*, which is one of the earlier and major expositions of accounting theory. The *Accountants Handbook*, to which he was the chief contributor and subsequently the editor of the second and third editions, is a standard reference book.

Professor Paton has had the conviction throughout the years that accounting principles should have a basis in economic theory. Also, he has had an appreciation of the importance of reliable accounting data in measuring economic activity and in observing economic trends. In his writings and teachings, he has made a significant contribution to the development of realistic economics and to the formulation of accounting principles consistent with that concept.

The Nominating Board, with genuine pleasure, presents William Andrew Paton, an inspiring teacher, notable author, and one whose leadership has been a real force in the development of accounting theory, for The Ohio State University Hall of Fame.

PRESIDENT BEVIS: Mr. Paton: For your outstanding contributions to the development of the accounting profession, upon the recommendation of the Nominating Board and under the authority of the University, I have the honor to inform you that your name has been placed in The Ohio State University Hall of Fame. In testimony thereof, I present you with the appropriate certificate duly signed and with the official seal of the University.

CHAIRMAN BROAD: Mr. President: The Nominating Board of The Ohio State University Hall of Fame presents Robert Hiester Montgomery.

A native of Pennsylvania, Colonel Montgomery was one of the founders of the firm of Lybrand, Ross Brothers and Montgomery, in which he is still active. He pioneered in accounting education as a member of the faculty of an evening school sponsored by the Pennsylvania Institute of Accountants as early as 1902. This subsequently led to the organization of a School of Accounts and Finance at the University of Pennsylvania where he later lectured during the school year, 1905-1906. He participated in organizing the first International Congress on Accounting held in St. Louis in 1904; he was chairman of the International Congress on Accounting held in New York in 1929; and he represented the American Institute of Accountants at the International Congress on Accounting in London in 1933. In addition, he was official representative of Columbia University at the International Congress on Accounting held in Amsterdam in 1926. As a professor at Columbia University from 1919 until 1931, he challenged the students in his classes to be faithful to their professional trust. Chaucer would have said of him: "Gladly would he learn, and gladly teach."

In the Spanish American War, Colonel Montgomery took part in the Puerto Rico Campaign. As a lieutenant colonel in World War I, he rendered distinguished service in the office of the Director of Purchases and elsewhere. Later, he served as executive secretary of the War Policies Commission in Washington and as director of research and planning under the NRA.

Over a span of 40 years or more, Colonel Montgomery has earned and received about all of the honors which the accounting profession can bestow and he has accepted and conscientiously discharged all of the responsibilities assigned to him. He was president of the American Association of Public Accountants, the predecessor of the American Institute of Accountants, from 1912 to 1914 and also held the presidency of the American Institute from 1935 until 1937.

His books on federal taxes and auditing have become accounting classics.

As one of the founders of this profession in the United States, as one who has been steadfast in the demand for high ethical standards especially during its formative years, as a teacher and author, and finally as a still active elder statesman who has been a continual source of inspiration to the young men and women entering the accounting profession, Mr. Montgomery has gained our wholehearted admiration. The Nominating Board is privileged to present for The Ohio State University Hall of Fame, Robert Hiester Montgomery.

President Bevis: Mr. Montgomery: For your outstanding contributions to the development of the accounting profession, upon the recommendation of the Nominating Board and under the authority of the University, I have the honor to inform you that your name has been placed in The Ohio State University Accounting Hall of Fame. In testimony thereof, I present you with the appropriate certificate duly signed and with the official seal of the University.

Chairman Broad: Mr. President: The Nominating Board of The Ohio State University Hall of Fame presents George Oliver May.

Born in England, where he received his early accounting training, Mr. May has been one of the real builders of the profession in this country. As senior partner of the firm of Price, Waterhouse and Company from 1911 until 1940, he envisioned through the years the professional character of public accounting, and he has been untiring in his efforts in building an edifice worthy of this foundation.

Mr. May has served as president and director of the National Bureau of Economic Research, as vice president of the American Economic Association, as director of the American Statistical Association, and as director of the Council on Foreign Relations. He has, in addition, been a lecturer on the faculty of the Graduate School of Business Administration at Harvard University. Conscious of the social responsibility of the public accountant in an economy of free enterprise, he has made noteworthy contributions to federal legislation and administrative regulations concerned with accounting concepts and determinations.

A farseeing and statesmanlike representative of the accounting profession and a deep student of economic theory, Mr. May has been pre-eminent in the development of accounting principles and was the first chairman of the committee on accounting procedure of the American

Institute of Accountants. His underlying philosophy holds accounting to the pragmatic test of usefulness to the economy as a whole and demands a virility strong enough to develop and grow—and to change if necessary—to meet the needs of a changing economy.

The literature of accounting has been enriched by his numerous articles in professional journals and by his books, *Financial Accounting* and *Twenty-Five Years of Accounting Responsibility*. To him, public accounting has always been a public trust.

Since his retirement from active practice, Mr. May has been performing yeoman service as research consultant for the Business Income Study Group, a body composed of economists, businessmen, lawyers, and accountants, which, under the sponsorship of the American Institute of Accountants and the Rockefeller Foundation, is striving to find the most useful concepts of business income.

The Nominating Board is proud to present Mr. George Oliver May, one of the country's outstanding practitioners, also an author and farsighted leader in the development of the basic philosophy of accounting, for The Ohio State University Hall of Fame.

PRESIDENT BEVIS: Mr. May: For your outstanding contributions to the development of the accounting profession, upon the recommendation of the Nominating Board and under the authority of the University, I have the honor to inform you that your name has been placed in The Ohio State University Accounting Hall of Fame. In testimony thereof, I present you with the appropriate certificate duly signed and with the official seal of the University.

LETTER FROM MR. MAY

I appreciate the honor which my fellow accountants have done me in selecting me as one of those who have "made outstanding contributions at any time to the field of accounting." Such contribution as I have been able to make has been largely in relation to Financial Accounting and the determination of income.

The task which Financial Accounting has faced, has been to move in the direction of certainty and simplicity in an economy which was moving rapidly in the direction of complexity and uncertainty, if not confusion. The task may be likened to that of the billiard player in "Mikado"—to control, as it were, the cue ball (of accounting classification) to bring together in proper relation the two object balls (of revenue and cost) on a cloth untrue (of contractual relations indefinite or deceptive in expression) with the twisted due (of ambiguous terminology and conventions) and the elliptical billiard balls (of an unstable monetary unit). And this has to be done for an audience which is wholly unaware of the defects of the equipment provided and which has been led to believe the task is easy.

The profession has striven earnestly to improve the "cue" of terminology and convention over which it has some measure of control. But even in this, it has been hampered by the fact that it is not autonomous, that it has no exclusive vocabulary, and that its conventions must always, in practice, be a compromise between theory and practicability.

I am happy that the Nominating Committee has seen fit to honor workers in this unrewarding field who cannot point to such contributions of demonstrable usefulness as have been achieved in Recording, Administrative and Tax Accounting.

My friend and contemporary, Robert Montgomery, whom I am glad to see honored today, has to his credit achievements in all the fields. He, like myself, drew inspiration from Arthur Lowes Dickinson, who brought us together in the work of the First International Congress of Accountants in 1904.

The contributions of William A. Paton have extended over a shorter period, but no one familiar with his record can fail to recognize the courage, insight, imagination, and scholarship that he has displayed.

The value of an award is measured, in part, by the quality of those into whose company one is received. In this case, the awards are being made for the first time, but the standing of the other recipients is such as to enhance the honor that has been done me.

It is good augury for the new project of the University that they should be among the first nominees, and I am grateful that my name should be associated with theirs in completing the list. It is, I think, a common characteristic of the three that all have displayed that readiness to reexamine one's own first principles that has been said by Mr. Justice Holmes to be the mark of a civilized man.

I extend to the University, whose accounting graduates are earning high praise for it, and to the Nominating Committee my thanks for their generous appraisal of my efforts. I regret that it has been impossible for me to be present to receive the award myself; I hope that in the near future I may be able to express my appreciation on a personal visit to the University.

George O. May

THE FUNCTION OF ACCOUNTING IN MODERN MANAGEMENT

By William Herbert Carr
President, The Controllers Institute of America, Inc.; California Packing Corporation, San Francisco, California

I have heard my subject—"The Function of Accounting in Modern Management"—discussed many times in recent years by accountants, educators, and business executives. It has been discussed so frequently, in fact, that a natural first reaction is—a lot of warmed-over hash! However, a brief review of business during the last decade shows that there is a *reason* for the continuous and vital interest in this general subject. That reason, I believe, goes back to the war and wartime controls.

During the war years, new problems arose almost daily. Constant changes were necessary as we sought for and devised new techniques to cope with the flood of regulations, special orders, and questionnaires we received from numerous government departments and agencies. Then came the end of the war and with it the problems of reconversion, contract termination, renegotiations, and a period of filling up the "pipe lines" of civilian supply. This was followed in time by readjustment to normal peacetime schedules and the problems of competition.

It is probable that at no time during this period did any large part of industry have its record-keeping and control procedures up-to-date. Under conditions of constant change, there was urgent need to find better and more efficient means of doing the work. This need led to increased cooperation within industrial groups. It reflected itself in the rapid growth of the Controllers Institute, the American Institute of Accountants, the Institute of Internal Auditors, and similar organizations. Regular conferences of these professional societies and special conferences like the one we are attending here had a phenomenal growth because they were serving this vital need.

Management is not a modern invention. Students of industrial history can cite many examples of the functioning of management, as far back as the early civilizations in Egypt and China. During the last century, manufacturing and trade, like agriculture, were conducted as small businesses in local areas. They were managed in most instances by the owners. Following the Civil War, business expanded quite rapidly. But it was not until the close of the 19th Century and the early years of the 20th Century that we experienced a phenomenal growth in many industries, and large corporations evolved. *Now* they have become an important part of our industrial and business life. In spite of that fact, today thousands of small enterprises—a large majority of our business concerns, in fact—are still owner-managed. However, the large corporations, almost without exception, are managed for the owners by a group of specially trained men.

It is this professional group of men—the men who operate this particular segment of American industry—that I have in mind as "modern management." This group, often called "top management," is responsible to directors and stockholders for the effective operation of the business. Their primary work is "far-sighted planning," creation of a sound organization, selection of key personnel, and development and use of effective means of control. All this is aimed at insuring that business may produce what the public wants, at prices the public will pay—and at the same time meet the demands of workers and investors, two groups whose interests often *seem* to conflict.

As business management evolved, changing as we have seen from personal supervision to management by organization, the need for records also changed. The increased size of plants, the geographic spread of distribution, and multiple plant operations each added to the need for records, reports, channels of communication, and control methods. While the accountant kept abreast of the times by meeting the requirements of industry in matters of current operations, outside forces, social and political, supplied the pressure which made for the rapid growth in the other accounting function of business in recent years.

It is hard to realize when we look back over the last thirty years how *many* changes have taken place. We have experienced great progress in the development and use of machinery and power. Tremendous advances have been made in all scientific fields. Many new industries have developed. There has been a continued growth in the size and complexity of business organizations. At the same time, business has felt the full impact of many social, political, and economic changes that took place during this period. Business has had to adapt itself to constantly changing conditions, mounting and burdensome taxes, and ever-increasing social controls.

The various revisions of the Federal Income Tax Law and Regulations, the Securities Act of 1933, The Securities Exchange Act of 1934, Federal and State Social Security Laws, and numerous other regulatory acts—each in turn has added to the reporting and record-keeping problems of business.

As each new record-keeping requirement developed, it was logically added to the duties of the Accounting Department, which had the basic records. This evolution in the accounting phase of business during the present century, particularly in the last thirty years, has produced what is known as the controllership function of today. It includes many duties not found in the Accounting Department of a few years ago; yet, accounting is still its chief tool.

In considering any separate function of business management, we should also keep in mind the other major aspects of an organization. This is particularly important in connection with the controllership function because it is concerned with *all* functions and all departments of the business; that is, with the recording, reporting, auditing, analyzing, and developing of controls for all activities of the organization.

In the average industrial organization today, there are basically five broad functional divisions:

First: The engineering, or product planning function, which is responsible for product specifications, and in many cases for the development of *new* products.

Second: The production function, which is responsible for the actual manufacturing of the product. This includes all of the responsibilities in connection with material, labor, and operation of the plants.

Third: The marketing function, which is responsible for the actual promotion, advertising, and selling of the finished product.

Fourth: The financial function, which is responsible for providing the necessary funds to operate the business and for the collection of accounts and credit.

Fifth: The controllership function.

While the basic duties of the controllership function are the same in all businesses, the *degree of responsibility* for related duties varies in different companies with the character of the business, precedent, and executive personnel. And it varies a great deal with the capacity of the individual controller. I believe the function of the controller in business, in its broad sense, may best be illustrated by quoting the revised definition of the controllership function recently adopted by the Controllers Institute of America. This is certainly the most up-to-date definition. It defines the function as follows:

1. To establish, coordinate and maintain, through authorized management, an integrated plan for the control of operations. Such a plan would provide, to the extent required in the business, cost standards, expense budgets, sales forecasts, profit planning, and programs for capital investment and financing, together with the necessary procedures to effectuate the plan.
2. To measure performance against approved operating plans and standards, and to report and interpret the results of operations to all levels

of management. This function includes the design, installation and maintenance of accounting and cost systems and records, the determination of accounting policy, and the compilation of statistical records as required.

3. To measure and report on the validity of the objectives of the business and on the effectiveness of its policies, organization structure and procedures in attaining those objectives. This includes consulting with all segments of management responsible for policy or action concerning any phase of the operation of the business as it relates to the performance of this function.
4. To report to government agencies, as required, and to supervise all matters relating to taxes.
5. To interpret and report on the effect of external influences on the attainment of the objectives of the business. This function includes the continuous appraisal of economic and social forces and of governmental influences as they affect the operations of the business.
6. —and last—To provide protection for the assets of the business. This function includes establishing and maintaining adequate internal control and auditing, and assuring proper insurance coverage.

It is obvious from this definition that the controller's functions cover in effect all phases of a modern business organization. It should be equally obvious that there is only time, in a talk of this kind, to comment briefly on some of the more important duties of the controller.

As a framework for my comments, I am dividing the controller's responsibilities into three broad classifications—internal control problems, internal policy problems, and external responsibilities. All of these activities help to define the function of accounting in modern management.

First, let us consider internal control duties.

If planning is to be effective and plans properly carried out, management must see that the activities of each department and each function of the business are properly conducted to this end. It is the controller's duty to furnish such reports and yardsticks to management that the effectiveness of each unit of the organization can be determined and controlled. Moreover, the larger the organization, the more important and the more difficult it is to keep all departments and executives informed about matters *outside* their own departments which have a bearing on their department's operations.

In particular, it is the controller's duty to see to it that proper financial controls are set up in all departments, with the necessary checks and balances. Through internal audit, he ascertains whether the policies are being properly carried out. When they are *not* being followed, it is up to him to see that the proper administrative officer is informed and the situation corrected. These are basic duties and the accounting background necessary for competent performance is obvious.

I think it is also fundamental that a controller should always be looking *ahead.* He should be constantly alert to the direction his company's affairs are taking. He should be aware of trends which might affect it in one way or another.

Among the controller's responsibilities there are also many policy problems. Their analysis and solution are by far the most important of his duties. For they can and frequently do exert an important influence on the direction and growth of a company and its eventual success. In "analysis and solution," accounting plays a prominent role, although a great deal of imagination, initiative, personal analytical ability, and constructive thinking are also of major importance. At times, considerable salesmanship ability is also necessary in order to achieve desired results. Many of these policy problems are also of importance because of their direct effect on statements of net income and financial position issued to stockholders, creditors, employees, and governmental agencies. I will limit my comments to several of these problems that exist in most business organizations today:

First: The basis of valuation of inventories.
Second: Determination of what is to be capitalized.
Third: Depreciation policy.
Fourth: Financial policy.

While the great majority of companies still use the conventional "first-in, first-out" method of inventory valuation, several other methods have been used for many years. There is the "Lifo," or last-in, first-out, method of inventory valuation. Interest in this method, and use of it in business, has been increasing since 1938. There has also been much discussion, pro and con, as to whether "Lifo" inventory is in accordance with good accounting practice. I believe it is now considered to be in good repute. Be that as it may, "Lifo" has shown that it has great value in many situations, if adopted at the right time. Often the use of "Lifo" inventory results in a far more realistic statement of earnings than is obtained under other methods. He must also make sure, through properly defined instructions, that the method of inventory valuation is consistently followed. If changes become necessary, he must make sure that any material effects on earnings are properly reflected and disclosed in the financial statement.

Another responsibility of the controller is the determination of what is to be capitalized. This is to be accomplished by clear and concise definitions and instructions for procedures to be followed in determining what charges are to be capitalized. However, many problems can arise even though a company has detailed manual instructions as to what expenditures can be capitalized, and what items are to be charged to expense. These problems vary greatly depending upon the complexity of the organization. Those firms which have frequent and substantial investment in unusual items and in intangible assets, such as patents, trademarks, etc., usually have to consider each item separately. Most organizations also have special problems from time to time to consider in connection with repairs, alterations of buildings, and the remodeling or partial replacement of equipment in production lines. In many instances, leased properties also complicate the determination of which expeditures should be capitalized.

The controller's third policy responsibility has to do with depreciation. Since the war, this has been one of the most widely discussed phases of accounting. Because of the rapid increase in prices during the last few years, charges to profit and loss for depreciation are not in sufficient amounts to equal the costs of new plant and equipment which must be acquired to replace that which has been worn out in production. Many accountants argue that profits have been inflated in direct proportion to the amount by which depreciation based on increased costs of new plant and equipment would exceed depreciation based on historical cost of the assets currently in use. On the other hand, many accountants assert that such is not the case. A controller should see that the management of his firm is fully informed on this point, and that the best possible opinion is properly reflected in the financial reports of his company. The amount of time given to the problem will depend on the importance of depreciable property in the particular business. This can be measured by the total dollars involved, the nature of the physical assets, the rate of replacement, and the potential effect of obsolescence in the industry.

Finally, there is the company's financial policy—probably the most important policy problem, in the broad sense, in any business. Financial policy covers not only the procurement of funds, but the coordination of the use of those funds. The controller is the logical person to direct the reporting and control work necessary in the preparation of summaries of funds available and funds needed. The first, funds available, involves estimates of sales, inventory turnover, and other sources of income. The latter, funds needed, includes a great variety of factors depending upon the business, the major items being the funds needed for current operations, payment of dividends, and investment in capital assets, either for replacement or for expansion of facilities. A part of the foregoing problem, but of sufficient importance to warrant the designation of a separate "policy" because of the direct and material effect upon the finances of the company, is that involving control of money invested in inventories. While this is sometimes considered a function of the sales and operating personnel, the controller usually belongs in the picture though the nature of his participation varies materially among industries and among companies. He is responsible for maintaining records and issuing reports to management concerning inventories. In the performance of this duty, he is in a position to point out where inflated inventory situations have developed. In practice, he has an important function in coordinating his company's sales, production, and purchasing and inventory programs in relation to the financial budget.

I should like to discuss, in the closing moments of this talk, the role of the controller and a function of accounting in modern management not usually associated with his office. I refer to *public relations*.

Basically, the controller's *external* responsibilities are to supply the data or prepare the reports for various government regulatory agencies, stockholders, and the public. Referring to this, a prominent business executive stated in a speech not long ago, "The general public, the Securities and Exchange Commission, and the public auditors are not greatly concerned with anything but over-all figures." This may be a factually correct statement, as over-all figures usually meet "legal requirements" and it is true the public's interest, in general, has been limited in scope until recent years. However, the ever-growing number of "investment counsellors" and the increasing tendency of brokerage houses to offer *analyses* of common stocks and even to publish brochures on the companies attests to the increasing interest in these facts which underlie the "over-all figures." Bare "legal requirements" no longer satisfy at least a *part* of the investing public.

If we include among the controller's responsibilities, the appraising of future effects of economic and social forces and the effectiveness of company policy, it follows that he has a vital responsibility in connection with his organization's public relations. The term "public relations" has been described as "doing the right thing and letting the public know what you are doing." Certainly, statements confined to over-all figures will never serve the purpose of letting the public know—and helping the public to *understand*—what we are doing.

No informed person would doubt that we have in America today, and have had for many years, the highest standard of living ever achieved by any country in modern times. Even in the depth of the last depression, our living standards were higher than those achieved by most of the countries of the world in good times. These achievements have not been realized through an abundance of natural resources, nor are they due to any special spiritual or mental qualities peculiar to our people. As this superiority is not due to physical advantages, it obviously must be due to the social and economic atmosphere in which it was developed—to individual initiative, to incentives—in short to our free enterprise system. But in the midst of all this, the great mass of our people are economically ignorant. There is little understanding and many misconceptions concerning business —its financial aspects, importance of cooperation, and management's contributions. This economic ignorance has been undermining and handicapping American business in recent years. This trend can be stopped only by positive efforts. American management, which *understands* the economic facts, has an opportunity to bring about great economic understanding through its reports not only to stockholders, but to employees, and to the public.

The actions and results of our complex business system are primarily measured by and expressed in the common language of figures. A controller, custodian of the records, is in a position to express and interpret figures in such a way that management can issue reports that will be readily understood. If the controller is to perform his part in public relations, he must be familiar with the scope of the problem. With such an understanding, he is in a position to suggest to management the kind of information that will convey readily-understood facts to the average person.

In closing my discussion on The Functions of Accounting in Management, may I repeat the first part of the sixth section of the definition of the functions of Controllership—"To provide protection for the assets of the business." Certainly, we have no greater assets in American business than personal liberty and the free enterprise system. To protect these, we must all do our part to persuade management to take positive action in educating employees, stockholders, and the public regarding the close relationship between personal liberties and the economic system we enjoy in America today.

FIFTH SESSION

SATURDAY, MAY 20, 1950—10:00 A. M.
Deshler-Wallick Hotel

Presiding:

FRANK P. SMITH, *Editor, Accounting Review; Dean, Graduate School, University of Rochester, Rochester*

Paper: "Recognizing Current Price Levels in the Profit and Loss Statement and in the Balance Sheet"

H. T. MCANLY, *Partner, Ernst & Ernst*

Paper: "A Reconsideration of Criteria of Realization of Business Income"

PERRY MASON, *President, The American Accounting Association; Professor of Accounting, University of California, Berkeley*

Paper: "The Internal Auditor as an Aid to Management Problems"

J. B. PARKER, *President, The Institute of Internal Auditors; The International Harvester Company, Chicago*

INTRODUCTION

CHAIRMAN SMITH: Our first speaker is Mr. H. T. McAnly, general partner of Ernst & Ernst. Mr. McAnly directs the activities of Ernst & Ernst throughout the United States in the fields of cost accounting, budgeting, industrial engineering, and other management consulting services. He has been associated with Ernst & Ernst for 30 years and is a C.P.A. in several states, a member of the Advisory Committee in Accounting at the College of Commerce and Business Administration of the University of Illinois, a member of the Advisory Board of the International Accountants Society, and a well-known speaker on cost accounting and related subjects.

Mr. McAnly has been interested for many years in the general problem of current costs and changing price levels. In 1941, he developed an acceptable application of "Lifo" for a number of industrial companies, which solved a serious problem caused by the complex nature of their inventories; he has been prominent in adapting "Lifo" to practical use in the retail field and served as the only professional accounting witness before the United States Court in the Hutzler case. More recently, Mr. McAnly has advocated the need for recognizing the decline in purchasing power of funds recovered through depreciation in order to reflect realistic figures of available net income.

It is a pleasure to present Mr. H. T. McAnly who will speak on the subject, "Recognizing Current Price Levels in the Profit and Loss Statement and in the Balance Sheet." Mr. McAnly.

RECOGNIZING CURRENT PRICE LEVELS IN THE PROFIT AND LOSS STATEMENT AND IN THE BALANCE SHEET

By H. T. McAnly
Partner, Ernst & Ernst

There is an old saying to the effect that nothing is certain save death and taxes. To these two, I would like to add one more—namely, currency devaluation under a tax-and-spend economy.

Internally, we do not call it devaluation. We call it higher prices. We remark that things "cost more." That is just another way of stating that the dollar is worth less than it used to be.

You will say, "Why, of course, everybody knows it. The dollar is only worth fifty cents today." If that is true, why don't we make some allowance for this situation in financial reporting? We are still using old dollars and new dollars as if they represented the same measurement of value. A balance sheet today is composed of a hodgepodge of 50-cent dollars and 100-cent dollars thrown together indiscriminately into totals that are both unrealistic and misleading.

My concept of accounting and financial reporting is to endeavor to present the facts as they actually exist. I do not think that we can present true facts by a method which uses two measuring sticks at the same time. The fact is that the dollar is no longer a common denominator. In order to use the dollar as a measuring stick, you must explain whether it is a prewar or postwar dollar. In fact, with price changes occurring as rapidly as they have during recent years, you may even have to differentiate between the dollar at the beginning of the year and the dollar at the end of the year.

It would seem that the accounting profession should set to work with determination upon a method of reporting financial results of company operations in terms of the value of the dollar *at the time the report is made.* I would like to present some suggestions along that line to you today.

I know that many of you may consider my proposals both radical and unnecessary—and I hope that you are right. It would be a wonderful thing, indeed, if we could look forward to a long period in which the value of the dollar would be stable, or even increasing. With such a prospect before us, we could probably continue to use our traditional methods, with the aid of adjustments, footnotes, and special provisions as and when required. But, unfortunately, on a long-term basis, currency stability is not in line with historical fact. Over the years, prices usually keep on going up and currency persists in going down.

I am not talking now about flash inflations due largely to instability of government, such as those that happened in Germany and France; I am referring to long-term trends under strong governments.

It is true that we have, in this country, a counterinflationary factor that has operated powerfully in the past and will continue to act as a brake on prices in the future. This counterinflationary factor is increased productivity brought about by technological improvement under the spur of competition. There are many people who believe that if we could eliminate the hazards of depressions and wars, better goods for more people at lower cost would be the normal course of events in the United States. They say that we were headed in that direction when the last war hit us and that the decline in the value of the dollar is purely an aftermath of the war. They say that if peace continues, prices under the renewed spur of competition and with the aid of still more improved technology will again start down.

The fact is, however, that if you will draw a long-term graph of the value of the dollar in the United States—covering a period of over 50 years—and average out the fluctuations, you will see a long-term upward trend in prices and a long-term downward trend in the value of the dollar, paralleling the growth in federal government activities and federal taxes. It reflects not government weakness but an increasing government participation in, and control over, the national economy, plus a steadily growing tax burden to support such participation and control.

There are various historical parallels. *The Roman Government, during the 300 years (approximate) from the time of Augustus to the time of Diocletian, was one of the strongest governments the world has ever known. But, during that period, there was a progressive expansion of government activities and taxes, and the denarius (a Roman coin) which was worth the equivalent of 20 cents in the time of Augustus was worth about one-half cent during the epoch of Diocletian. The current historical parallel is the pound sterling.

When you add the possible requirements of national defense, plus annual wage increases demanded and gained by labor unions, to present-day deficit spending policy, I certainly doubt that we can look forward to a period of dollar stability. It will be wonderful if it happens, but the safe method is to devise ways and means of accomplishing factual financial

* Haskel—*The New Deal in Old Rome.*

reporting that may be put into use if we discover that today we are merely experiencing a temporary lull in a long-term trend of upward prices and downward value of the dollar.

With that background, let me get down now to specific cases. Let us start with the *income account.* This contains two items differently related to price changes. The first of these is depreciation which is related to *long-term* changes in prices and dollar value—on the average, a cycle of about twenty years. The second aspect is cost of sales which is related to inventory price changes *during the year currently reported.* I shall discuss these in the above sequence, showing how they are both related in principle, and then suggest a reporting format by which they can be handled realistically in terms of the current rather than the historic value of the dollar.

A great number of words have been wasted in recent years in arguing whether depreciation is a matter of recovery of capital invested or a question of recovering sufficient funds for replacement. This argument represents wasted words because of the fact that depreciation today, as an accounting factor, consists in most cases of whatever amount the United States Treasury will allow you to take as a tax deduction, and obviously, under today's circumstances, this amount is insufficient either for recovery of capital invested (adjusted to the value of the current dollar) or for replacement of physical assets.

In the case of most companies, a large share of present depreciation allowances applies to physical assets purchased back in the days when the dollar was still worth 100 cents. Allowances on such items are still figured as if the dollar continues to be worth 100 cents, whereas, in fact, it is only worth about 50 cents. A dollar is of value only in terms of what it will buy. The fact is, therefore, that depreciation allowances such as those I have just described do not represent recovery of capital invested—they represent, at current dollar values, the recovery of only *one-half* of the capital invested. By the same token and for the same reason, present recovery is utterly insufficient for replacement. This is obvious by comparing equipment and materials prices with those which applied ten years ago. So I repeat: Depreciation allowances under present practice are utterly unrealistic. They do not represent recovery of capital, are inadequate for replacement, and represent merely what Uncle Sam allows tax-free.

The results of this practice are not only misleading, they are dangerous. If a company takes on its books only the depreciation allowed by the government, it is meeting, with respect to assets purchased on a prewar basis, only about one-half of its actual depreciation requirements. It is, therefore, overstating its earnings to the extent of its depreciation deficiency. This has an entire series of unfortunate results:

First—A company has to pay federal income tax upon a portion of so-called earnings that are not actually earned and will never be realized.

Second—Labor and government base their opinions of corporate earnings upon amounts as reported today. Therefore, labor and government get an inflated idea of profits which paves the way for more wage and tax demands.

Third—If a company pays out a major portion of earnings, as reported under today's system, in dividends, it is actually giving away a part of its needed capital, for a portion of the earnings disbursed in dividends does not in fact exist as earnings available for distribution.

Fourth—The balance sheet becomes a hodgepodge compiled partly out of 100-cent dollars and partly out of 50-cent dollars and is therefore no longer an accurate picture of the company's financial condition.

Under present circumstances, not much can be done about the tax angle of this situation—that is something for future Congressional action. But we *can* do something today with respect to our accounting and reporting methods. If we will revise these methods in order to give a realistic picture of what is actually happening, this, in itself, will, I believe, exert a powerful influence on Congress to enact new provisions concerning depreciation allowances and accompanying tax relief.

To reduce this question from the abstract to the concrete, let me repeat a simple example which was used in an article published in the October, 1947 issue of the *Controller*, entitled "Preserving of the Integrity of Equity Capital."

Let us assume that a company purchased a machine in 1935 for $1,000; that the machine is scrapped in 1947 without any salvage value; and that the index of prices in 1947 is 180 as compared with 100 in 1935.

A rise in the index from 100 to 180 is equivalent to saying that the value of the dollar has dropped from 100 to 55 cents. If this company has been following conventional straight-line depreciation methods and has estimated the life of the machine correctly at twelve years, it will have recouped $1,000 of depreciation in the sale of its products, or the original purchase price, by 1947. This balances off the account for the machine on the company's *books only*. To compensate for the fall of the dollar to 55 cents, the company actually should have recovered $1,800 to have the equivalent of the $1,000 of 100-cent value it invested in 1935. Looking backward from the vantage point of 1947, it is apparent that during this 12-year period, the company has overstated realized earnings and has depleted the capital required to continue as a going concern by $800.

What should be done accounting-wise with that $800? Remember, that represents the additional amount of depreciation, which, in today's 50-cent dollars, that company must have *just to stay even with the game.* If it is not to impair its capital, it needs this money to apply against recovery of capital for replacement of facilities.

Since this represents a deficiency, I think that this item should be labeled "depreciation deficiency" and deducted in the *income account*, reducing reported earnings to that extent.

It should then be carried over onto the balance sheet as a reserve to prevent impairment of capital.

The above example demonstrates conclusively that existing practice concerning depreciation operates fairly only when there is no change in the purchasing power of the dollar during the life of the asset. We need a practicable means of providing for depreciation on a current price level basis—a means that, if recognized accounting-wise, may eventually be recognized tax-wise.

Before I further into suggested accounting procedures, I want to pause long enough to dispose of the argument put forward in some quarters that "accelerated depreciation" is the answer to the depreciation dilemma.

Accelerated depreciation is sound in theory to the extent that it provides for the write-off of an asset during the useful economic life of that asset. For example, machine tools that usually have a life of many years may, owing to the rate of technical improvements in the industry, frequently become obsolete in a much shorter period, and their useful economic life should govern the annual quantity of their write-off. Likewise, high production activity calling for multiple-use operation certainly decreases the life of depreciable assets, but the accelerated depreciation theory only deals with the quantity of depreciation to be taken annually and ignores the change in the value of the dollar. In the case of companies owning plant and equipment bought with 100-cent dollars as compared with current dollars, it completely ignores the basic problem, that is, providing the necessary funds for reinvestment in assets in order to continue operations.

In a given instance, "A" agrees to supply "B" with 100 potatoes a month for one year, starting with January 1, but the potatoes keep getting smaller and smaller. By June, the potatoes are only half the size of those delivered in January. "B" complains to "A," and "A" then offers, "All right, I will speed up my delivery on the rest of the potatoes. I'll give you the rest of them at the rate of 200 per month." What would "B" say? He would reply, "Well, that will be fine, up to the end of September—but what will I use for potatoes after that?"

That is what would happen in the case of depreciation continuing on assets purchased at other than current value dollars if accelerated depreciation, alone, were permitted today. The money could be recovered faster, but there would still be the same deficiency. All that accelerated depreciation would do in such a case would be to speed up the recovery of too little—and the tax relief it would afford during that shortened period would be offset by lack of a deduction in the future tax period.

What we need is a recognition of the change in the purchasing power of all funds being recovered in depreciation, the adjustment in the depreciation provision representing a reserve to prevent capital impairment.

It is also obvious that any method used to determine only the annual quantity of cost to be written off falls short of this mark. The adjustment, to be realistic, must allow for the change in the value of the dollar from the date the asset was originally purchased to the end of the fiscal year being reported. In other words, adjustment of depreciation to conform to change in the value of the dollar should include not only adjustment covering provision for the current year but also for all prior years.

Such a method has as a prerequisite a reliable index of the current value of the dollar. It is my suggestion that our government issue such an index. There is nothing inherently startling in this suggestion—it could easily be done by the application of facts already gathered and issued by the government. Consider the Department of Labor Cost of Living Index, for instance. The obverse of this index is obviously an index of the value of the dollar. Perhaps a better base might be the Wholesale Commodity BLS Index.

The depreciation provisions for the year could be computed on any of the generally accepted bases—the straight-line method, the diminishing balance method, the production method, or any combination thereof.

The accumulated reserve for depreciation on cost at the end of the year should be broken down into the amounts which apply to the assets by years of acquisition. The accrued depreciation applicable to the assets of each year of acquisition should be adjusted for the difference between the index of that year and the current index. The total of the adjustment would represent the total depreciation deficiency. The difference between the amounts so determined at the beginning of the year and the end of year would represent the accumulated additional depreciation deficiency.

The additional depreciation deficiency covers both the amounts applicable to the current year's provision and the adjustment of the prior years' provisions. It is doubtful whether the latter would ever be recognized tax-wise as a current deduction item. However, the depreciation deficiency applicable to the current year's provision should be permitted tax-wise as long as the accumulated amount of these annual contributions does not exceed the total deficiency computed on the accumulated depreciation reserve.

In a period of declining prices, the reduction of the deficiency provision applicable to prior years would become a credit to surplus. The adjustment of the current year's provision (either calling for a greater or lesser provision) would be reflected in the income determination.

Assets should be depreciated until the reserve for depreciation on cost equals the original cost expressed in current dollar values, regardless of the amounts which previously may have been provided for additional depreciation and credited to the reserve to prevent impairment of capital.

This reserve can be adjusted at the time fully depreciated assets are removed from the depreciation reserve, thus transferring the related portion of the reserve to an appropriate capital account and permitting all additions to enter the property records at the dollar level as of the date of their acquisition. Subsequent value and depreciation thereon would again be figured on the cost, with adjustments for additional depreciation based upon the relationship of the current dollar index to the value of the dollar at date of acquisition.

Now we come to the $64 question—can we ever hope to get a tax deduction of the full measure of annual depreciation as calculated on the above basis? This, of course, is of paramount consideration. It would have an important bearing on realized net earnings.

There is a great deal of wishful thinking about the subject of taxes. People say, "There ought to be some way of cutting down this tax load." It is not the function of accountants to seek tax relief. It *is* their responsibility to do honest financial reporting. Let us concentrate on that function. Then, *if* honest and realistic financial reporting indicates clearly that present depreciation deductions are insufficient, Congress may eventually be expected to do something about it.

I think that factual reporting must come first. How can we expect Congress to accept the truth of our claims if they are not reflected in our own reporting?

We make the *claim* that depreciation allowed by the government is not enough, but that is not the story generally told in our *income account* and our *balance sheet.* The story we tell the stockholders in our reporting is the government's story—not ours. We have "cut the cloth" to fit the government; I suggest that we conform to the facts. Then Congress may realize that what we claim is really the truth and be encouraged to take some action concerning it.

You may feel skeptical, indeed, as to whether Congress would ever permit an index of the value of the dollar to be used as a basis for computing deductible depreciation. There is a precedent for a realistic tax policy toward depreciation in the "last-in, first-out" principle of inventory pricing in the computation of taxable income. This principle is essentially a preventative measure against the inflation of profits-on-paper resulting from excessive inventory valuation in a period of rising costs. It eliminates the levying of tax on inflated profits which result from writing up the continuous necessary inventory investment to current values. Thus, as inventories are turned over, the latest current replacement costs incurred are charged against operating income and the balance sheet value of the inventory is carried at a constant prive level. While the means for providing depreciation on a current price level basis on physical properties is admittedly more difficult and less tangible than dealing with inventories, this is certainly no justification for ignoring a reasonably accurate solution.

In approaching a method for tax relief on depreciation, we need not concern ourselves with specific replacement values, since we are merely seeking a practical means to adjust the funds—the dollars—which are being recovered, through depreciation provision, to their present purchasing power. We must recognize that the estimated life of an asset, which determines the annual write-offs, is not an exact determination but represents only reasonable judgment. The degree of accuracy of the index used in such adjustment is also not of paramount importance, as long as reasonable recognition is given to the decline in value of the dollar and as long as the same index is made available to all taxpayers.

The objections to the use of a more or less arbitrary index in adjusting allowable depreciation provisions have centered around the idea that this is a deviation from the generally allowed practices of permitting only actual costs incurred as income tax deductions. Yet, there are a number of present practices which have been found necessary in a sound approach to income determination that do deviate from the use of actual cost incurred in computing equitable allowable deductions in the computation of taxable income:

Specific percentages of income are allowed for depletion in computing the taxable income in the production of oil and minerals which have no relation to any write-off of cost of properties or acquired assets.

Even the theory of lower of cost or market permits the company to write down a value to market, although these actual values have not been introduced into the company's records in trading transactions as of the date of the fiscal year.

In the application of the "last-in, first-out" principle for the retailer, in order to permit the retailer to have the same opportunity to carry his continuous necessary inventory investment at a frozen price level as in the case of taxpayers in businesses with less complex inventories, the Bureau of Labor Statistics now publishes indices covering the price changes in classifications of merchandise which the retailer is permitted to use in the computation of taxable income to reduce the current value and thus write off against income the latest replacement costs incurred.

As I said earlier in this discussion, under traditional accounting methods, the balance sheet today becomes an unrealistic miscellany of dollars of varying degrees of value. Earnings are overstated because of the failure to reflect certain items of operating cost at current cost price levels. I have explained this picture with respect to depreciation and the long-term price cycle. Now I want to go into similar detail with respect to inventory.

Let us assume that at the beginning of the year, a company has an inventory valued at $1,000,000 and that there is no change in the quantity of inventory during the year, but prices during the course of the year go up 10 per cent. So, at the end of the year, the inventory has a valuation of $1,100,000. Under the traditional first-in, first-out method, that $100,000 of increased value enters into the computation of the cost of sales and so increases net earnings by that amount. The company also pays income taxes on this $100,000.

However, the fact is, of course, that the company never realized that $100,000 of profit. It did not have the money—all it had was the merchandise. That $100,000 of profit would be realized only upon liquidation. But a company cannot liquidate its inventory and stay in business. A working amount of inventory is as essential to the conduct of business as are other items of working capital and physical facilities.

If a retail store owns its own building in a downtown location and, because of the rapid growth of the city, the building appreciates in value during the year, is the company compelled to pay income tax on that appreciation in the value of the building? Then why should it have to pay income tax on appreciation in value of inventory? Both are essential, continuing requisites of doing business.

It was the realization of this principle that led to the development of the "last-in, first-out" method of inventory valuation, known, of course, as "Lifo."

Under "Lifo," inventory of equivalent quantity is valued at the end of the year at prices as of the first of the year, regardless of price changes during the year.

In the case of my previous illustration of a company which had an inventory valued at a million dollars at the beginning of the year but

$1,100,000 at the end of the year, under "Lifo" this inventory would still be valued at $1,000,000, its value at the beginning of the year. Therefore, $100,000 of unrealized profit would *not* be added to reported net income, would *not* be subject to federal income tax, and would *not* be transferred to earned surplus.

If there was an increase in inventory during the year, the increase *only* would be valued at current prices.

From the standpoint of savings in federal taxes in a period of advancing prices, the benefits of "Lifo" are obvious. Of equal importance, to my mind, however, are its benefits from the standpoint of assisting honest and factual reporting. The reporting of unrealized, or "paper," profits as actual earned income gives a false impression to labor unions, to government, and to stockholders, and may even tend to delude management itself.

The history of "Lifo" is interesting indeed. Briefly summarized, here is what has happened:

The principle of "Lifo" was first recognized as applying to inventories of like measurable substances. The traditional illustration is an inventory of 1,000,000 pounds of metal in a company which required an inventory of this volume in order to conduct its normal flow of business. It was easy to see that a company with such standard inventory could no more realize a price increase on this quantity during the year than could a pipe-line company with a pipe line full of oil. However, inventory is inventory, whether it consists of lead or of miscellaneous related merchandise. The "Lifo" principle applies to the investment in inventory, regardless of its complexity.

It is comparatively easy to visualize the application of "Lifo" to a uniform product or to a major cost element which is common to all products. Thus, a million pounds of lead at five cents per pound at the beginning of the year would represent a $50,000 beginning inventory investment. If a million pounds existed at the end of the year and the current cost at that point equaled 7½ cents a pound, it is easy to see the mechanics which permit the valuing of the million pounds at the beginning of the year price level of 5 cents, thus removing the 50 per cent increase in cost price level from the ending inventory value of $75,000 at current prices.

Let us now consider a $50,000 beginning inventory, representing a group of diversified but related products, such as a line of products produced by a manufacturer or the merchandise in any recognized departmental classification in a wholesale or retail business. Let us assume that at the end of the year this inventory investment valued on a current basis represented an aggregate increase in cost of 50 per cent, thus reflecting a total cost value on a current basis of $75,000.

Application by items of the principle of "last-in, first-out" would permit the removal of the cost price increase of $25,000 in the case of the company having one product, but would permit only a portion of this increase in the case of diversified items, unless the exact quantity proportions that existed in the beginning inventory were also present in the ending inventory.

In a group of products, it would be very unusual if the same relative quantity of each item or all of the same items were present in both the beginning and ending inventories. The wider the line of products within the group or the more subject to style change, the greater the possibility of relative quantity variations of the items in the beginning and ending inventories. Also, the wider the line, the greater the aggregate minimum inventory investment.

Thus, if individual item quantities are used rather than an aggregate valuation of the group, the relief offered through "last-in, first-out" will be in inverse ratio to its relative need. Therefore, unless products can be considered in related groups and reduced to a common unit, the application of the "last-in, first-out" principle will not produce an inventory value which clearly reflects income. For some types of product, approximate physical quantity units are available. For the vast majority, however, equitably weighted physical quantity units are not readily obtainable.

In 1941, in order that all items in a related group of products could be expressed in a common unit, we introduced the idea of the "dollar value method" of applying "Lifo." This treats dollars of investment at a specific price as the common unit. In the application of the "last-in, first-out" principle, the specific price level is "cost" at the beginning of the first year of the use of the principle. The use of a basic dollar value as the common denominator makes the application of "Lifo" practicable regardless of the complexity of the inventory.

The determination of the quantity increase of a group of related products can be accomplished by the extension of the individual product quantities in the beginning and ending inventories at the same prices, or by removing the price increase (or decrease) reflected in the ending inventory valued at current cost. To do that, it may be only necessary to determine the percentage changes in an acceptable specific company or general price indices applicable to the various groups of related products.

A number of industrial companies adopted this dollar value method as early as 1941. Likewise, a group of retailers used it; the decision handed down by the United States Tax Court in 1946 in the Hutzler

Bros.-Baltimore department store case approved the dollar value method and the use of indexes. Subsequently, the Bureau of Internal Revenue agreed to accept index figures developed by the Bureau of Labor for retail "Lifo" application. More recently (November 1949), T.D. 5756 was issued which permits the use of the dollar value application by any taxpayer, retroactive to 1941, providing, of course, that the years are open and that the "Lifo" method had been elected by the taxpayer at the time of filing the original return.

Unfortunately, far too few companies adopted "Lifo" in 1941 before the price inflation trend began. The statute in its present form does not permit the use of market value if market becomes lower than "Lifo" cost. Until such time as market is permitted with "Lifo" (the same as is permitted with first-in, first-out cost), many companies will not adopt "Lifo" tax-wise because of the inherent danger of freezing too high a cost price level.

A survey conducted by the National Industrial Conference Board covering 559 cooperating companies for the year 1947 indicated that 22 per cent of these companies were using "Lifo." Of the companies in the group whose individual assets exceeded $100,000,000, over 44 per cent of these used "Lifo" and the total inventories of this group equalled about one-half of the total inventory value of the 559 cooperating companies.

We must keep in mind that this tabulation covered a period before there had been any general acceptance or recognition of the dollar method. The "Lifo" principle had only been in existence since 1938—nine years—and only narrow applications had generally been followed. In more recent years, the "Lifo" dollar value method for determining corporate income has been adopted by an increasing number of companies who did not adopt it tax-wise in the early forties because of the narrow interpretations then contained in the regulations.

The Revenue Code should be amended so as to permit the introduction of market values if market prices go below cost computed under the "Lifo" basis. This would then remove all guesswork as to whether the cost price levels are low enough at a particular time to adopt this sound principle. The recognition of the dollar method of application which makes a practical application of "Lifo" possible for any company, coupled with the use of the lower of "Lifo" cost or market, would clear the decks of all obstacles and would permit all industries to adopt this method of inventory pricing for both corporate and taxable income determination.

Now that practical means exist for keeping price increases out of inventory quantities that equal the aggregate beginning inventory, thus making a practical application of "Lifo" possible for any company, it would seem that much confusion in financial reporting could be eliminated if there was universal adoption of the "Lifo" principle of pricing. How confusing it must be to a layman when it becomes apparent that management has a choice as to a method of inventory pricing which can greatly affect the earnings that are reported annually?

For example, I recall an individual case of a company which, in computing earnings in a period of sharp price increases in some of the major commodities in their inventory, passed up the use of "Lifo," because they needed a better earnings picture in connection with a stock issue to support contemplated market value of some additional stock to be sold.

We should be able to get together and decide on a single basis of inventory pricing, and it would seem quite obvious that the universal acceptance of "Lifo" would tend to stabilize business profits generally and thus be of real benefit to the social and economic fabric.

Following World War I, a large number of companies suffered inventory losses which, in reality, merely represented profit inflation that was never realized during the war period. One outstanding example was that of a large company whose decline in inventory prices equalled $1,000,000 a day for thirty days.

Profiting from that experience, a number of these companies, during this last inflationary period, through the use of "Lifo" or inventory reserves which are its equivalent, have refrained from calling the price increase in their continuing investment in inventory during that period a profit, and hence they will not be faced with these write-downs. Furthermore, to the extent that the long-term general price level can be expected to be upward, the portion of the price increase which becomes more or less permanent will never be considered profit, since it has not been realized and will not be until such time as the company liquidates its full inventory investment.

Now let us assume that a company uses "Lifo" and also employs the method of depreciation determination that I have suggested today. What treatment can we give the balance sheet under such circumstances in order to make it a realistic statement of financial reporting?

Let's start with this very simple balance sheet:

Current Assets		$ 800,000
Plant Assets—Original Cost	$1,000,000	
Less: Allowance for Depreciation	500,000	500,000
TOTAL ASSETS		$1,300,000

Current Liabilities		$ 400,000
Capital Stock		200,000
Earned Surplus		700,000
TOTAL LIABILITIES		$1,300,000

Let us assume that the current price index is 200 as compared with 100 at date of acquisition of plant assets. Our first step is to set up a reserve to prevent impairment of capital covering the adjustment of the accumulated depreciation without attempting to adjust balance sheet asset amounts of either plant or inventory to reflect current price levels. The balance sheet now looks like this:

Current Assets		$ 800,000
Plant Assets—Original Cost	$1,000,000	
Less: Allowance for Depreciation	500,000	500,000
TOTAL ASSETS		$1,300,000
Current Liabilities		$ 400,000
Capital Stock		200,000
Reserve to Prevent Impairment of Capital covering Accumulated Depreciation		500,000
Earned Surplus		200,000
TOTAL LIABILITIES		$1,300,000

Now let us introduce the adjustment of the plant amounts as well as the accumulated reserve to cover the change in the price index from 100 to 200. The balance sheet now looks like this:

Current Assets		$ 800,000
Plant Assets—Cost at current price level	$2,000,000	
Less: Allowance for Depreciation on cost at current price level	1,000,000	1,000,000
TOTAL ASSETS		$1,800,000
Current Liabilities		$ 400,000
Unrealized Appreciation—Net Plant Assets		500,000
Capital Stock		200,000
Reserve to Prevent Impairment of Capital covering Accumulated Depreciation		500,000
Earned Surplus		200,000
TOTAL LIABILITIES		$1,800,000

For the last step, let us assume that the company's current assets contain a "Lifo" inventory amount which is $300,000 under current replacement market and $200,000 under actual cost incurred. This fact is now introduced into the balance sheet along with previous adjustments, and here is the final result:

Current Assets (with inventory at current replacement cost)		$1,100,000
Plant Assets—Cost at current price level	$2,000,000	
Less: Allowance for Depreciation at current price level	1,000,000	1,000,000
TOTAL ASSETS		$2,100,000
Current Liabilities		$ 400,000
Unrealized Appreciation:		
In Net Plant Assets	$ 500,000	
In Inventory Cost	100,000	600,000
Capital Stock		200,000
Reserve to Prevent Impairment of Capital covering:		
Accumulated Depreciation	$ 500,000	
Inventory Cost Increase	200,000	700,000
Earned Surplus		200,000
TOTAL LIABILITIES		$2,100,000

From the above examples, it can be readily seen that other balance sheet items can be adjusted to current cost as long as proper explanation is set forth in the offsetting account—"Unrealized Excess of Cost at Current Price Level Over Incurred Cost."

The "Reserve to Prevent Impairment of Capital" is properly a portion of the capital structure representing a provision out of income of the capital needed to cover the continuing plant and inventory investment. The "Unrealized Appreciation" represents the "Excess of the Current Price Level Over the Net Cost Investment" in plant and inventories and merely reflects the additional capital requirements (not yet realized from income) which will be needed to continue the existing plant and inventories at the current cost price levels. In reality, this unrealized excess of replacement cost over cost is a charge against future earnings to be recovered as the plant assets expire and the inventories are turned over in operations if the current price levels continue.

Thus, since the adjusted depreciation to cover price level changes is provided for out of current earnings and "Earned Surplus" is adjusted to cover the accumulated depreciation affecting prior years, corresponding amounts should be transferred from the "Unrealized Appreciation" to the "Reserve to Prevent Capital Impairment." Therefore, as the depreciable assets are used up, the equivalent of the capital required to replace them has been accumulated in the "Reserve to Prevent Capital Impairment." Also, as price levels change, the adjustment of the net plant investment and cost inventory investment to current value is rectified accordingly with an offset in the "Unrealized Appreciation Accounts."

In these illustrations, you have a method of reporting financial results in dollars that are all the same size—whatever size the dollar happens to be at the end of the year reported.

Suppose we could really get this new method rolling as a trend in accounting—a trend embracing a vitally important principle—what would happen?

First—It would show management and stockholders the extent to which invested capital is impaired by the decline of the dollar unless this decline is offset by reserves accumulated out of income; in addition, it would indicate the amount of reserves required.

Second—It would give the Internal Revenue Department measurable statistical evidence of the unfairness of today's federal tax procedures, especially those with respect to depreciation allowances. If these results were brought about, could it be long before Congress would take action?

Third—It would provide labor and the general public with profit figures in line with actual facts, instead of today's hypothetical totals that arouse criticism and resentment.

Remember, just because the government calls something taxable income does not make it profit. The Revenue Code, itself, recognizes this in the carry-back and carry-forward loss provisions. There is nothing in S.E.C. regulations that says a company must make the same report corporate-wise that it does tax-wise. What we have been showing the public in too many cases is how Uncle Sam arrives at the amount of taxable income. Let us tell the public how much profit is actually earned.

Much of the propaganda put out today by economists employed by labor unions, etc., containing many statements of only partial truths, etc., is the indirect result of the confusion which is apparent in the accounting profession regarding what is profit. If we are unwilling to state the facts and thus provide proper charges against income to cover current values as we turn over our inventories and our plant assets in the operations of the business, how can we expect labor, consumers, and stockholders to recognize that a portion of these inflated profits are in reality nonexistent, have not been realized, and, therefore, are not available for distribution?

CHAIRMAN SMITH: Thank you Mr. McAnly, for a very fine paper.

I am not sure whether our next speaker, Professor Perry Mason, will take issue with Mr. McAnly or whether he will be sympathetic with the remarks which you have just heard. Regardless of his position on the purchasing power of the dollar question, I am certain that his analysis will be penetrating and invigorating.

Formerly a professor at the University of Michigan, the University of Kansas, Antioch College, and the University of California at Los Angeles and Berkeley, he is currently professor of accounting and associate dean of the School of Business at Berkeley, as well as president of the American Accounting Association.

Professor Mason has a Ph.D. degree from the University of Michigan and is a C.P.A. in both Michigan and California. He is well known as a writer in accounting journals and is the author of the monograph, *Principles of Public Utility Depreciation*, and a popular text in accounting, *Fundamentals of Accounting*. It affords me great pleasure to present Professor Perry Mason who will speak on the topic, "A Reconsideration of Criteria of Realization of Business Income."

A RECONSIDERATION OF CRITERIA OF REALIZATION OF BUSINESS INCOME

By PERRY MASON

President, The American Accounting Association; Professor of Accounting, University of California, Berkeley, California

In an intelligent visitor from another planet were to spend some time in this country in an attempt to understand its habits, customs, and so-called civilization, there are many things which undoubtedly would puzzle him. Each one of us would be able to make a little list of his own of these queer aberrations. My own list of things, the reasonableness of which I should find it difficult to explain to the visitor, would include most radio commercials, Miss America contests, flagpole sitters, our farm-price support program, and the antics of political campaigns. And I should certainly add to the list of things difficult to explain the accountant's calculation of realized business income. Let us take a look at some of the things we accountants do.

The most commonly used basis for recognizing earned revenue is the sale. If a grocer buys a can of peas for 15 cents, expecting to sell it for 18 cents, we say, "Let's wait until he does sell it before we recognize any profit," and that is certainly a reasonable position. He is in the retail business where his entire activity is focused upon the making of sales to his customers. To show a profit of 3 cents before he had found a customer for the can of peas would obviously be a silly procedure.

But now notice what happens if the wholesale price of canned peas changes. If, at the end of a year, the can of peas is still unsold and the wholesale price has gone up from 15 cents to 16 cents, we sit back and smile with satisfaction. If the price to the customer remains at 18 cents, the grocer will still make his 3 cents of profit, and if the price goes up to 19 cents or 20 cents, he will make that much more. Until he sells the can of peas, we do not know how he will come out, so we sit tight.

However, suppose that the wholesale price drops to 14 cents. Then, under the time-honored policy of "cost-or-market-whichever-is-lower," we get hot and bothered about the situation. "Oh! Oh!" we say, "he may not make 3 cents profit when this can of peas is sold since the selling price may drop to 17 cents." So, in spite of the fact that the grocer has not carried out our profit-determining step of selling the can of peas, we write down the inventory to 14 cents and take an immediate loss of one cent.

If the can of peas is sold during the next period for 17 cents, we show the normal profit of 3 cents; however, if all of this had taken place within one accounting period, we should merely have shown a profit of 2 cents on the sale, the direct result of buying and selling operations. What we have done is to take a loss in one period and a higher profit in the next period than if we had stuck to our original proposition that the sale is the proper criterion of profit realization. To put it another way, we seem to accept the curious proposition that a rise in cost is not a realized profit but a fall in cost is a realized loss. All of this would certainly be confusing to the visitor from another planet and certainly is always confusing to my students.

Let us take a look at another case. A corporation buys some shares of stock of another corporation as an investment of excess cash, to be held as a current asset under the title of Marketable Securities. At the end of the next accounting period, it is discovered that the issuing corporation has earned a net income of $5 a share but, due to its requirements for expansion, its directors have decided to limit the dividend to $1 a share. The book value per share, therefore, goes up $4 a share and, since market values reflect so many complex factors, we shall assume that the market value rises only $3 a share. What do we as accountants do in this situation? We record the $1 of dividends as income for the period and usually do nothing else. The stockholder of the corporation which holds the shares of stock is left blissfully ignorant of the fact that the market value and book value of this asset of his corporation have had a marked increase. For all he can tell, without making his own investigation, the issuing corporation just earned enough to pay this small dividend, and the realizable value of this highly liquid asset is no greater than when the shares were acquired.

If, however, the issuing corporation suffers a loss and does not pay a dividend, the accountant snaps to attention. Both book value and market value drop, and we ordinarily are quick to recognize this in the accounts and statements. No longer do we wait for the sale of the shares before recognizing any change in the situation. We refuse to record an increase in market value because, as we say: "Why, the market price may drop before we get around to selling the shares—what goes up must come down." But when the market price falls, we do not seem to realize that the price may come up before we sell the shares. It is all very confusing.

This previous illustration also relates to our peculiar concept of dividends as income. In a partnership, we say that an individual partner earns his share of the partnership income at the same time that the partnership, as a separate business entity, earns it. But of the partners incorporate, we insist that the former partners, now acting as stockholders, do not earn anything until they, now acting as directors, go through a bit of formal "mumbo-jumbo" to distribute a portion of the assets of the corporation to themselves. Actually, a very good case can be made for the proposition that dividends are not income at all, but rather that the stockholder, like the partner, realizes his income as the corporation earns it. At least, we would have a more sensible income tax if this point of view were adopted.

Another peculiarity in the accounting mind at work is the handling of contingencies. If our client is engaged in a lawsuit in which he will probably have to pay damages, we, at least, set up an estimated liability and may even reduce the amount of current net income to provide for it. We do something similar if it looks as though we are headed for a period of falling inventory values. We are very careful to mention and to provide for all estimated and contingent liabilities. But we are almost wholly inconsistent when it comes to contingent assets. I do not believe that I have ever heard of anyone advocating that we pay much attention to showing the probable amount collectible in an unsettled law suit as an asset, and seldom is it suggested that we ought to write up an inventory because prices have risen or are apparently on the way up. How can a present or prospective stockholder, a banker, or anyone else, act intelligently if he only knows one side of the financial picture?

Here is another situation which would certainly perplex our visitor. Companies A and B, we shall assume, are manufacturing concerns which are identical in every important respect. Company A is practically shut down and just earns enough to cover its shutdown expenses and therefore shows neither gain nor loss on its income statement. Company B, on the other hand, after a period of shutdown is working twenty-four hours a day replenishing its stock of products, has made firm contracts for their sale, but has made no deliveries during the period under consideration. Company B's income statement would look about the same as Company A's and even the balance sheet might not appear much different. A very important set of facts does not show up in the accounting records and statements, all because we must wait for the completed sale before recognizing any realized income.

The problem of the recognition of income is made still more confusing, because we sometimes abandon the sale as our basis and go to extremes in both directions. In gold mining, we take the position that production, rather than sale, is the proper criterion, and we value the inventory of unsold gold at approximately its selling price so that the profit gets assigned to the period of production rather than to the period of sale. We often do the same thing in farming operations. I believe it is customary in stock raising, for example, to debit calves and credit cows when a calf is born and then to place an inventory value upon the cow; the net result is to take the income from natural increase in the herd in the period of production rather than the period of sale. Then, we sometimes go to the opposite extreme and insist that there is no realized profit until we have cash on the barrelhead. The installment method is the most common example of this point of view.

We could go on listing and describing these puzzling peculiarities of accounting procedure, but let us stop and see if we can discover the reason for this predicament. If we accept the proposition that income should be recognized only when all of the more significant events have occurred, which would lead us to the conclusion that the sale has been or will be completed within a short period of time with little or no additional cost, we have something logical and consistent with which to work. The ordinary retail sale fits this concept. The valuing of produced gold and farm products at selling price, or close to it, is obviously proper, since little or no selling effort and costs will be required and a firm market price can easily be determined. The spreading of the profit on long-term contracts over several periods in proportion to the percentage of completion becomes reasonable, since the contract of sale has already been made and production becomes the principal activity. The installment sale method, under this concept, is sensible since there is often considerable doubt as to the ability of the purchaser to carry out his contract; this method is also practical because substantial expenses in connection with the sale are yet to be incurred. This is a good guide to follow and we should probably use it more than we do.

Much of what we do and the most confusing results arise from the so-called principle of conservatism, and I should like to take a few sound whacks at this venerable notion. First, what do we mean by "conservatism" in accounting? Apparently, we mean that we go out of our way to recognize expenses, losses, and liabilities, but almost fall over backward in our attempts to postpone the recognition of income, gains, and assets. If we can find a possible alternative, we always choose the one which gives us the lower profit in the *present* accounting period. It has always puzzled me as to why this attitude or practice was ever called "conservative." The dictionary defines the word as "having power to conserve or preserve, disposed to maintain existing institutions, opposed to change or innovation, and so on." A much better term would have been "pessimism"—the opinion or doctrine that everything in nature tends to the worst, a disposition to take the least hopeful view of things.

How has it come about that accountants have acquired such a bad case of ingrown pessimism? I believe there are at least three reasons. In the first place, we have been encouraged to adopt this point of view by the bankers and other extenders of credit. I recently attended an important meeting of accountants during which we were addressed by a representative of the bankers. During the discussion which followed, the speaker expounded to the effect that any method which led to lower asset figures on the balance sheet would meet with his approval. Bankers have traditionally encouraged the creation of secret reserves as a substitute for careful investigation and good judgment. I believe, however, that the picture is changing. Just a few months ago, I listened to a speech by another banker, and much to my surprise I found that he was taking a very enlightened point of view. He seemed to realize that the real security back of a business loan was earning power, and that the important thing in making a loan is to assume continued operations, not liquidation. He was anxious to have accountants prepare statements which, to the best of their ability, presented the facts of the case, not a distorted set of figures in the traditional manner. If, for example, the prospective borrower has followed the customary practice of writing off his fixed assets using the highest rate of depreciation he can get away with for tax purposes and then charging no depreciation at all to operations once an asset is fully depreciated (even though it continues in use for some time), he may present a beautifully pessimistic balance sheet. However, his income statement, once the asset has been fully written off, automatically becomes dangerously optimistic and inaccurate. While it may be true that the bankers have led us down this dismal path, I believe they are having a change of heart and will in the future be more interested in the whole truth rather than a distorted version of it. At least, we should do our best to educate them in that direction.

A second possible reason for our pessimistic habits is that owners of businesses are apt to be incurable optimists. We, as accountants, have sometimes felt that we have to be careful not to present too rosy a picture of the results of business operations or our client or employer will grab the ball and in his enthusiasm run toward the wrong goal line. I used to have a client in the real estate business who, after I had prepared his balance sheet on a "conservative" cost basis, used to sit down, recalculate the figures using the selling price of all of his unsold subdivision lots, and then start planning on how he would spend his profits. Six months later, he went through a receivership. This optimism, of course, presents a real problem but I do not believe that our traditional pessimism is the answer, particularly since a policy which results in the lowest possible income this year will usually produce abnormally high income in the next or some subsequent period. If we have given the owner the most accurate figures possible and have attempted to educate him as to what they mean, we have, in my opinion, afforded him the best type of service.

A third explanation may be that we accountants have welcomed the opportunity to slant our figures toward the more pessimistic side, because we were only too well aware of the inevitable inaccuracies which are inherent in our adoption of short arbitrary accounting periods and in other phases of our calculations. We know that in spite of our best efforts we are going to be wrong, and we have a hunch that our client or employer is going to react less explosively if he finds out that he actually made more profit than we had estimated than if the contrary were true. I doubt, however, if this has been too important a factor, and I should certainly take the position that we are performing our duty as accountants only if we try to present the truth and the facts as we see them.

There is, of course, a fourth factor which I shall merely mention—the effect of the income tax law and regulations. Clients naturally expect us to keep their taxes at a minimum and are apt to ignore historical evidence and assume that taxes cannot possibly go any higher. It seems to me that the time has long since passed when we can use the tax return as an adequate guide to business management and investment. We must prepare alternative figures which make more sense.

Being more of an evolutionary than a revolutionary temperament, I am not going to propose anything very drastic as a solution. In general, I believe we do a relatively good job, but I would like to drag down that old decrepit God of Conservatism from its pedestal and replace it with a Goddess of Truth. If we are actually faced with apparently equal alternatives, of course we are wise to choose the more pessimistic answer, but to go out of our way to keep asset values down and liabilities up through such devices as cost or market, excessive depreciation rates, and reserves for various contingencies set up out of income is, in my opinion, unwise and performs a disservice rather than a service to our employers and clients (to say nothing of other people who expect to get something useful out of the financial statements).

No longer are the financial statements of concern only to the management, the banker, and the tax collector. Minority stockholders, prospective investors, and employees, it is now felt, are entitled to nearly as much information as the insiders. Also, financial statements now have political repercussions. Business is harmed if, through intentional policies, assets are understated today and, as a result, expenses are understated later on, since the apparent rate of return on the investment is higher than the actual facts would indicate, and business gets an inequitable deal in legislation and in labor negotiations. How can a stockholder arrive at an intelligent decision as to whether he should sell his shares or buy more if he does not have all of the facts and estimates? How can a prospective investor make a reasonable decision if he has to work with one-sided information? For that matter, how can management proceed effectively on the basis of figures slanted toward pessimism?

Perhaps we should give some thought to the establishment of criteria for a new concept—the recognition and disclosure of *unrealized* income and losses. What would be wrong or objectionable about calculating realized income on a straightforward basis, such as the sale or production, and then indicating in a supplementary statement that in the light of evidence available during the preparation of the financial statements, it appears that additional revenue or additional losses will become realized during the following or subsequent periods? Such a supplementary statement would cover both increases and decreases in the replacement cost or in the expected margin of profit of inventories, both increases and decreases in the value of marketable securities, the expected results of law suits, etc. Favorable expectations are just as important as unfavorable ones to everyone concerned. I am, of course, not advocating that we should go too far on such a proposal. We cannot, and should not, attempt many predictions of the future. But I wonder if a few steps in this direction would not make our statements much more useful than they often are.

My purpose in raising some of these questions is merely to stir up the matter and urge you to think seriously about it. What accountants do is something of a mystery to students, to bankers, to investors, to labor, and even, at times, to management. We should act in every way possible to make our procedures clear and consistent. It is imperative that we realize the advisability of questioning established institutions to make sure that they have not outlived their usefulness.

Chairman Smith: Thank you, Professor Mason, for your most interesting paper.

Our next speaker, Mr. J. B. Parker, a C.P.A. of Illinois, will concern himself with a different type of problem. Mr. Parker is a divisional comptroller of the Wisconsin Steel Division of the International Harvester Company and a member of the Controllers Institute and the Institute of Internal Auditors. It is now my pleasure to introduce Mr. J. B. Parker who will speak on the subject, "The Internal Auditor as an Aid to Management Problems." Mr. Parker.

THE INTERNAL AUDITOR AS AN AID TO MANAGEMENT PROBLEMS

By J. B. Parker
President, The Institute of Internal Auditors; The International Harvester Company, Chicago, Illinois

You have all been subjected for many years to bombardment by advertising for cigarettes. As exaggerated as the claims for smoking any particular brand may appear, they are mild compared to what the early users of tobacco in the 16th Century said in behalf of its virtues. They claimed that in addition to many other things, the tobacco fumes would cure practically everything including catarrh, headache, and stomache-ache, and if inhaled in certain months, it would also cure toothache, dropsy, and gout.

Some business people believe that internal auditors also claim a great deal more as the objectives for their profession than they can really attain. However, I think we can say that it is universally true that all young and energetic organizations are ambitious. Despite any claims which may appear to be exaggerated, we should recognize that the internal auditor is limited in his activities by a major consideration over which he has no control; that is, the extent to which management will allow him to operate in a particular field. His welfare depends to a major degree on the interest shown in the objectives of his group by top management, and this is true, I believe, of all staff groups.

For example, one of the major reasons, in my opinion, for the success of the safety campaign initiated by the U. S. Steel Corporation in 1908, with the safety staff who were originally called "casualty managers," was the sincere interest evidenced in it by Judge Gary. He was always concerned with the safety and welfare of the worker and by his interest and action imbued the worker with the feeling that the company also was interested in the safety of the working man. We may, also, conclude from the foregoing that it does not make a great deal of difference to whom in the organization a staff group reports (which has been a source of much contention in the past) as long as the organization is aware that top management believes in the objectives of the staff and the staff in turn accomplishes these objectives by selling itself to the rest of the personnel.

Evidence will point to many problems of management which the internal auditor has helped to solve. Before giving you some illustrations of what internal auditors are doing today, it seems appropriate to offer for your consideration a few general remarks as to why and how the internal auditor is useful to management.

First, we must recognize that most individuals tend to overemphasize their own point of view and also to believe that others think and act more like themselves than they really do. This is particularly true of professional men having specialized training, such as accountants and engineers. The result is that in a great many cases, reports are prepared with the belief that those for whom the reports are intended know more of the subject than they actually do. For example, most of the criticism of annual reports in the past emanated from the fact that the reader could not understand the accounting terminology.

The internal auditor, as a result of his company-wide experience, likewise may have a different slant or point of view from that of the accounting or operating personnel in a particular department. Of course, it should be kept in mind that it is just as helpful to management to be assured by an impartial audit that everything is according to Hoyle as it is for errors to be brought to light.

I believe all of you will agree that the major role of supervisors is to interpret and pass communications from top management down the line to the worker and on the other hand for them to receive communications from or prepare reports about the worker and pass them up the line so that policies may be properly formulated by management. One of the most important services the internal auditor can render is to determine if supervisors are correctly interpreting the policies and transmitting those affecting the workers down the line to them without changing the meaning, either intentionally or unintentionally.

Under present day conditions of complex business organization, top management can only concern itself with broad general policies, and the internal auditor can contribute a great deal to insuring that these broad policies are interpreted accurately and carried out effectively. For example, the internal auditor is often in a position to judge how company policies are being carried out at various outlying plants or branches because of his firsthand knowledge of how these policies are being executed at other locations.

You are no doubt acquainted with instances where, for example, an economy policy on the part of the local manager has been carried to the point where quality and continuous production may be sacrificed because supervisors dislike asking for funds for proper maintenance of machines or property. In one instance, an internal auditor was assigned to conduct an audit of a plant which was not easily accessible to transportation. He discovered that the property had become increasingly run down as a result of neglect and that extensive rebuilding was necessary. Annual requests for funds to restore the plant as submitted by the division had been turned down repeatedly and no responsible officer of the company had visited it for many years due to the time involved in reaching the location. The auditor took both notes and pictures of the property and the audit report submitted combined comments and photographs. As a result, the poor condition of the property was brought home forcibly to management. Since the plant was a valuable part of the company in question, it was only a matter of a few weeks after the filing of the report before steps were taken to restore the plant to a satisfactory physical condition.

It is often true that the internal auditor will discover that certain sales policies or practices conflict with the company's interests. For example, in an automobile business, the internal auditor department found that the cost of reconditioning some of the models taken in trade substantially exceeded the resale price of these models. These transactions amounted to a considerable loss before they were stopped.

How many of you are reasonably certain that the internal controls over your billings are sufficient to insure accuracy and that all shipments are invoiced? If your pricing is complicated, your internal auditor may give you valuable help in making sure that your prices are being figured correctly. A company in the steel industry, for example, had an auditing department which was not satisfied to overlook the pricing and billing section because of its complications. An expert familiar with the tangled maze of steel prices was enlisted into the internal auditing fold, and with his aid the first year of checking steel invoices uncovered underbillings of thousands of dollars.

There's an old expression about "throwing good money after bad." Here is an illustration of it in actual business practice. Sam Brown, a truck driver employed by a local trucking firm, drove his truck, which he owned independently, to a service station for repairs. As he had no credit rating, his company agreed to guarantee his account to the extent of $50.00 which was understood to be the estimate of the bill. The bill actually came to $100.00; Sam's trucking company refused to pay the difference, and it was charged to Sam's account. Later, the service station foreman gave Sam several truckloads of scrap intending that Sam should sell the scrap, return the proceeds, and pay his account thereby. Sam took the scrap but failed to return. Both the service station manager and the shop foreman acknowledged that they had given Sam the scrap in an effort to secure payment of his account. As naive as this may appear to be, it is analogous to a company which extends additional credit to a firm lacking working capital in the hope that eventually the debtor will get on his feet.

Are purchasing departments, to cite another example, always 100 per cent efficient? Your internal auditor may find that millions of dollars of material are being purchased without adequate information as to quantities on hand or stocks in transit. Purchases may be awarded to the lowest bidder without sufficient knowledge of his financial standing and ability to produce on a dependable basis. Competitive bids may be waived without proper follow up to see if the waiver is warranted. I have in mind a deal whereby material was bought at a price below the market from a company which also furnished other materials; no competitive bids were sought on these other materials. The internal auditor discovered that the high prices paid for these other materials offset the savings on the material purchased at a price under the market by over 1000 per cent.

How sure can management be that the company's property is being honestly handled and safeguarded? No one thinks a talk about internal auditing is complete unless it includes an embezzlement case. Here is one which happened to my own company.

In the fall of 1946, the attention of our internal audit department was directed to the fact that a filling station in the state of Kansas was selling large quantities of spark plugs, packaged in cartons with the company's trademark, at a fraction of the registered wholesale price of the units. The auditor, in checking the express records at the point of sale, found an unusually large number of shipments to the gas station classified as household goods and also miscellaneous merchandise originating from a small town in Southern California. Shipments were quite heavy and involved substantial value. With this information, an auditor in California was therefore assigned to discover the identity of the shipper. It was disclosed that the shipper was in the employ of the company at a small transfer house. He had previously resided in Kansas and was well known in the city where the gas station selling the goods was located.

An audit was immediately started of the records at the transfer house, and it was found that a shortage in stock of over $40,000 had occurred within a short period of nine months since the previous audit at that operation. The investigation indicated that not only had merchandise been shipped to Kansas from this transfer house, but also a portion had been carried into Mexico. A detailed analysis was made of the stock which revealed that many high valued items in addition to the spark plugs were unaccounted for. At that time, those items were in short supply and the demand was extremely heavy from sales outlets not only in the United States but in Mexico as well. It was found that most of the embezzled stock had been removed after regular hours, taken to the employee's home, crated, and then shipped by him via express or delivered in his car at various locations.

During the course of this audit, the employee involved was assigned to other duties away from his usual point of employment. He was not familiar with the investigation until he was confronted with the facts, which he emphatically denied. The auditors then contacted the gas station in Kansas and were able to obtain the checks payable to the company's employee for substantial amounts. In view of the fact that it was proved that the shipments of stolen property exceeded $5,000 in value on an interstate basis, the employee was tried in a federal court. All the time while on bond, he consistently professed innocence of the irregularities. However, the auditors were able to present concrete evidence in court, and after three days, the defendant broke down and requested his attorney to withdraw his plea of not guilty and to enter a plea of guilty as charged. He received a prison sentence and fine with no probation allowed.

This example is an excellent illustration of how quickly an irregularity can develop into a sizeable sum.

Can the internal auditor help to assure management that all is well in the producing division? He has found in some instances that large expenditures have been made without proper authorization for work comprising a capital nature. An audit of a plant payroll recently revealed that during the year under audit, piecework earnings were paid on over 4,000 items in excess of the number of items reported on the production records. A further check indicated that the same situation existed in the case of over 3,000 inspection tests.

In an investigation of a casting yard, the internal auditor's report showed that over 50 castings of certain kinds had been ordered in recent months, despite the fact that none of these particular castings had been used from the stock of similar castings which had been on hand for several years. In another instance recently, the auditor reconciled scrap accumulated from production with sales to scrap dealers and uncovered a loss of almost 2,000 tons of scrap in less than a year.

Only time, space, and your patience limit my examples of instances of how the internal auditor has been of help to management. I should like to mention one more way which is overlooked by many companies.

Many firms today are recognizing the value of the internal auditor's experience when it is necessary to fill supervisory and managerial positions.

	Without Adjustment		*Adjustments to Cover Accumulated Depreciation Only (Index 200)*		*Additional Adjustments to Cover Net Plant Assets Write-Up (Index 200)*		*Additional Adjustments to Cover Lifo Inventory to Market (300,000 Above Lifo Cost—200,000 Above Actual Cost)*	
CURRENT ASSETS		$ 800,000		$ 800,000		$ 800,000		$1,100,000
PLANT ASSETS	$1,000,000		$1,000,000		$2,000,000		$2,000,000	
Less: Allowance for Depreciation	500,000	500,000	500,000	500,000	1,000,000	1,000,000	1,000,000	1,000,000
TOTAL ASSETS		$1,300,000		$1,300,000		$1,800,000		$2,100,000
CURRENT LIABILITIES		$ 400,000		$ 400,000		$ 400,000		$ 400,000
Unrealized Appreciation								
In Net Plant Assets.........						500,000	500,000	
In Inventory Cost							100,000	600,000
Capital Stock		200,000		200,000		200,000		200,000
Reserve to Prevent Impairment of Capital Covering:								
Accumulated Depreciation ...				500,000		500,000	500,000	
Inventory Cost Increase							200,000	700,000
Earned Surplus		700,000		200,000		200,000		200,000
TOTAL LIABILITIES		$1,300,000		$1,300,000		$1,800,000		$2,100,000

They have discovered that executive positions can be filled capably by internal auditors not only because of their technical experience but also because of their training in getting along with people. When plant or branch managers need an endorsement of their recommendations for promotion, the auditor often is in a position to give management a valuable opinion of the qualifications of individuals being considered for promotion.

It is impossible for me to conclude my remarks this morning without commenting on the seriousness of our tax rates and public debt in this country. What does it avail private enterprise to initiate economies in business at every opportunity only to see the efforts dissipated by mounting governmental expenditures and waste? The bitter facts, of course, are that the battle against higher taxes is a losing one when the voting public believes that the benefits they are receiving more than offset the taxes they pay. For example, how can social security taxes be lowered when so many voters believe that their responsibility for dependents can be transferred in part or whole to the government?

We have all listened attentively to many talks about the perils of the increasing government costs, and most of us have been disheartened by the feeling of inability to do much about them. I sincerely believe, however, that there is a way in which we accountants can help to impress John Q. Public with the high taxes. A separate listing on the price tag of all articles, showing the tax share assigned not only to the company making the final article but also to those companies contributing any part thereto, would be eye-opening. I know of no other way to bring home to the consumer the realization of what taxes are costing him. It is a pity that business is forced to withhold the income tax from workers' pay, for employees thereby have become indifferent to the tax and are only interested in the net amount they receive from the company. It is my belief that business must employ every means at its disposal to make it evident to the consumer that in the long run the government service he votes for is only returned to him as part of the cost of what he buys. Let us see if we can help to show Mr. Public!

It is time to bring to a close the Twelfth Annual Institute on Accounting of the Ohio State University. This has been a most successful Institute and as participants we owe a vote of thanks to the Accounting Faculty of Ohio State University. As chairman of this session I should like to express the appreciation and thanks of the Accounting Faculty of the Ohio State University to all who participated in this Institute.

Meeting adjourned.

CONFERENCE ROSTER

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ANDERSON, MACDONALD W., Crucible Steel Company, Midland, Pennsylvania
ANKERS, RAYMOND G., Lybrand, Ross Bros. & Montgomery, New York City
APPLEBY, R. G., The Tappan Stove Company, Mansfield
AREND, CARL A., Armco Steel Corp., Middletown
ARMSTRONG, DOYLE A., Reed & Sutermaster, Tiffin
ASH, ROY, Norman Products Company, Columbus
ASSION, LEE T., The Buckeye Steel Castings Company, Columbus
AYLSTOCK, E. J., South-Western Publishing Company, Cincinnati

BAKER, C. L., Kurz-Kasch, Inc., Dayton
BALMERT, ALBERT E., Anchor Hocking Glass Corp., Lancaster
BARRETT, R. H., General Maintenance & Engineering Company, Columbus
BARSTOW, C. WELDON, Trout & Barstow, Dayton
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BAZLEN, R. A., Heidelberg College, Tiffin
BEALS, WENDELL E., University of Kentucky, Lexington, Kentucky
BEAMER, E. G., Haskins & Sells, Cleveland
BEARD, LOWELL D., Wall, Cassel & Gronewig, Dayton
BECHER, G. GEORGE, Dayton Power & Light Company, Dayton
BECKER, G. R., Capital Finance Corp., Columbus
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BELL, DOYT E., The Bonney-Floyd Company, Columbus
BENDER, ROBERT L., Ernst & Ernst, Cleveland
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BETSCH, W. D., The Ohio Fuel Gas Company, Columbus
BEVIS, HOWARD L., The Ohio State University, Columbus
BEYER, HARMON, Arthur C. Jahn & Company, Columbus
BIEHN, ORLAND L., Detergents, Inc., Columbus
BLASER, J. P., Meaden & Moore, Cleveland
BOEHM, R. T., C.P.A., Columbus
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BOLAND, JOSEPH R., Bell Coal Company, Columbus
BOLON, DALLAS S., The Ohio State University, Columbus
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BOWMAN, HERBERT W., Farm Bureau Mutual Automobile Insurance Company, Columbus
BOYD, ROBERT J., Detroit Harvester Company, Zanesville
BOYLES, MR. AND MRS. GLEN M., Glen M. Boyles, C.P.A., Lima
BRADMILLER, LIONEL F., Wall, Cassel & Gronewig, Dayton
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BRELESFORD, E. C., Thompson Products, Inc., Cleveland
BRINKMAN, HARRY N., The Lennox Furnace Company, Columbus

BROAD, SAMUEL, Peat, Marwick, Mitchell & Company, New York City
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BROWN, W. K., The Lennox Furnace Company, Columbus
BUCCALO, JAMES N., Keller, Kirschner, Martin & Clinger, Columbus
BUEHLER, RICHARD A., The H. C. Godman Company, Columbus
BURNHAM, WALTER C., The Ohio State University, Columbus
BUSHKUHL, JAMES B., Reed and Sutermaster, Tiffin
BUTCHER, GLEN, The Sunray Stove Company, Delaware
BYRD, H. MAX, Farm Bureau Mutual Automobile Insurance Co., Columbus

CAMERON, ROBERT V., Gerlach & Company, Columbus
CAMPBELL, E. F., The Fyr-Fyter Company, Dayton
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CARR, WM. HERBERT, California Packing Corp., San Francisco, California
CARRITHERS, JAMES M., University of Illinois, Urbana
CARTER, JAMES G., Michigan State College, E. Lansing, Michigan
CASE, HARRY N., Lybrand, Ross Bros. & Montgomery, New York City
CAYIA, E. D., Inland Steel Company, Chicago
CECIL, JOHN W., F. & R. Lazarus and Company, Columbus
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CHAPIN, GEORGE A., Ernst & Ernst, Columbus
CHRISMAN, G. BURGAN, Chrisman & Edwards, Dayton
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CLARK, L. FREDERICK, Wall, Cassel & Gronewig, Dayton
CLARK, WILLIAM E., Reed & Sutermaster, Tiffin
CLARKE, EDMUND A., Haskins & Sells, Cleveland
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CLINGER, RALPH H., Keller, Kirschner, Martin & Clinger, Columbus
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COHEN, ALBERT H., University of Michigan, Ann Arbor, Michigan
COLE, WILBUR, Tiffin
COLLINS, GEORGE R., New York University, New York City
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CONLEY, DONALD P., The Cottingham Paper Company, Columbus
CONLEY, FRANK M., City of Detroit, Detroit, Michigan
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CREWS, GAYLON R., Monsanto Chemical Company, Dayton
CRITES, DEAN, State Tax Department, Columbus
CROWN, HOWARD, Wright Harlor Purpus Morris & Arnold, Columbus
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CURL, JOHN W., Keller, Kirschner, Martin & Clinger, Columbus
CUTHBERTSON, HARRY W., Arnold, Hawk & Cuthbertson, Dayton

DANIELS, G. A., The Hydraulic Press Mfg. Company, Mt. Gilead
DAVIS, C. X., Battelle & Battelle, Dayton
DAVIS, G. B., Farm Bureau Mutual Automobile Insurance Company, Columbus
DAVIS, J. B., Ernst & Ernst, Columbus
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DEAL, PEGGY, Ernest E. Siegel, C.P.A., Cleveland
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EYERMAN, R. F., Norman Products Company, Columbus

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FRANKE, NORMAN, The Gilmanton Salesbook Company, Cleveland
FRAVERT, HARRY J. W., Monarch Marking System, Dayton
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FROEBE, JOHN A., Fenn College, Cleveland
FRYE, LOU S., H. C. Godman Company, Columbus

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GIFFORD, WILLIAM R., Crucible Steel Company of America, Midland, Pa.
GILLESPIE, WILLIAM H., JR., Trout & Barstow, Dayton
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HEINEMEYER, D. L., University of Miami, Oxford
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HOFFMAN, J. M., Battelle & Battelle, Dayton
HOFFMAN, W. E., The Lennox Furnace Company, Columbus
HOLLANDER, GEORGE W., Air Materiel Command, Middletown
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HOPKINS, LEONARD L., Keller, Kirschner, Martin & Clinger, Columbus
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HUNDLEY, KERMIT, Charleston National Bank, Charleston, West Virginia
HUNTER, MARY F., University of Toledo, Toledo

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JACKSON, ERNEST F., Armco Steel Corp., Middletown
JACKSON, JOSEPH, University of Dayton, Dayton
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JANSSEN, H. H., The Union, Columbus
JENCKS, WILLIAM B., The Ohio State University, Columbus
JOHN, R. O., The B. F. Goodrich Company, Akron
JOHNSON, C. S., Detroit, Michigan

KATZMAN, HERBERT M., The Cleveland Electric Illuminating Company, Cleveland
KEEBLER, WILLIARD P., University of Miami, Oxford
KEEN, R. H., The Lennox Furnace Company, Columbus
KEIM, ROBERT D., Winders Chevrolet Company, Columbus
KELLER, JOHN G., Keller, Kirschner, Martin & Clinger, Columbus
KELLER, LAURANCE D., Keller, Kirschner, Martin & Clinger, Columbus
KELLERMAN, R. C., Deloitte, Plender, Griffiths & Company, Cincinnati
KELLY, CARL F., National Electric Coil Company, Columbus
KELSEY, GEORGE W., Cashmere Corp., Cleveland
KEMP, DWIGHT H., Air Materiel Command, Fairborn
KEMPER, HAROLD G., Ohmer Corp., Dayton
KENT, RALPH E., Arthur Young & Company, New York City
KESTER, E. L., City of Dayton, Dayton
KIMPEL, HENRY M., City of Cleveland Heights, Cleveland Heights
KIRCHER, PAUL, University of Chicago, Chicago, Illinois
KOCH, CLEMENT G., Arthur Andersen & Company, New York City
KOHRING, CARL H., Public Accountant, Columbus
KONKLE, FELIX R., Lingo & Konkle, Columbus
KONZ, FRANK A., U. S. Army General Depot, Columbus
KORK, LOUIS D., Lybrand, Ross Bros. & Montgomery, Cleveland
KRAUSS, E. L., The Federal Glass Company, Columbus
KROPP, J. TRACY, Peat, Marwick, Mitchell & Company, Cincinnati
KUHNLE, H. C., F. J. Heer Printing Company, Columbus
KUNTZ, CHARLES A., The Ohio State University, Columbus

LAKS, ERNEST A., Cleveland
LANGDON, ELMORE C., W. E. Langdon & Sons, Columbus
LAPP, ARNOLD W., University of Toledo, Toledo
LARVA, JAMES H., C.P.A., Columbus
LATHEM, JAMES O., Detergents, Inc., Columbus
LATTANNER, CHARLES R., Farm Bureau Life Insurance Company, Columbus
LEHRER, JOSEPH, Public Accountant, Cleveland
LEIS, ROSS O., Ernst & Ernst, Columbus
LEISTER, ROBERT W., F. & R. Lazarus and Company, Columbus
LELAND, THOMAS, Texas A. & M. College, College Station, Texas
LEMKE, B. C., Michigan State College, East Lansing, Michigan
LINGO, JAMES A., Lingo & Konkle, Columbus
LONGANBACH, L. H., The Ohio Fuel Gas Company, Columbus
LOTT, STANLEY C., Lott Manufacturing Company, Columbus
LOWRIE, JOSEPHINE A., The F. & R. Lazarus and Company, Columbus
LUDWIG, CLIFFORD, Ohio Wesleyan University, Delaware
LUTZ, ROWLAND, Columbus Coated Fabrics Corp., Columbus
LYLE, HARRY C., The Ohio State University, Columbus

MAERKER, HARRY, The Ohio State University, Columbus
MAIN, FRANK W., Main and Company, Pittsburgh, Pennsylvania
MALLERY, RICHARD B., Delco Products Division, G.M.C., Dayton
MARPLE, R. P., NACA, New York City
MARSH, WILLIAM F., Lybrand, Ross Bros. & Montgomery, Pittsburgh, Pa.
MARTIN, JOHN C., Keller, Kirschner, Martin & Clinger, Columbus
MARTIN, W. H., Kent State University, Kent
MARVIN, E. D., The Wood Shovel and Tool Company, Piqua
MASON, PERRY, University of California, Berkeley, California
MATTHEWSON, D. R., Delco Products Division, G.M.C., Dayton
MCANLY, H. T., Ernst & Ernst
MCCLINTOCK, J. B., Farm Bureau Mutual Automobile Insurance Co., Columbus
MCCOY, JAMES R., The Ohio State University, Columbus
MCGUIRE, CATHERINE G., Self, Columbus
MCGURR, F. J., John Carroll University, Cleveland
MALISH, J. ROBERT, Hercules Steel Products Corp., Galion
MENGES, DAVID J., The McKay Co., Pittsburgh, Pennsylvania
MERRICK, DONALD W., Ford Motor Company, Royal Oak, Michigan
MERS, WM. H., C.P.A., Cincinnati
MIDDLETON, G. T., Ernst & Ernst, Columbus
MILES, ROBERT C., Ranco Inc., Columbus
MILLER, HERBERT E., University of Michigan, Ann Arbor, Michigan
MILLER, HERMANN C., The Ohio State University, Columbus
MILLER, JOHN K., The Wartburg Press, Columbus
MILLER, ROBERT L., Youngstown College, Youngstown
MILLER, WILLIAM H., Miller, Miller and Associates, Dayton
MISCHLER, JAMES J., The Hobart Mfg. Company, Troy
MITCHELL, WALTER, JR., Controllers Institute, New York City

MOEHRMAN, ROBERT L., Columbus and Southern Ohio Electric Co., Columbus
MOLL, ARTHUR B., Van Benschoten, Moll & Flaskal, New York City
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MONROE, PAUL, Battelle & Battelle, Dayton
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MOORE, V. J., Meaden & Moore, Cleveland
MYERS, HERBERT LEWIS, JR., Wright-Patterson Air Force Base, Dayton

NEIL, HOWARD L., Monarch Marking System Company, Dayton
NEWELL, C. C., The Buckeye Steel Castings Company, Columbus
NICOL, L. H. C., Automotive Parts Company, Columbus
NICOL, W. B., Meaden & Moore, Cleveland
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NOBLE, DONALD L., The Wooster Rubber Company, Wooster
NOBLE, PAUL L., The Ohio State University, Columbus
NOETHLICH, F. H., Bonney-Floyd Company, Columbus
NOETZEL, A. J., JR., John Carroll University, Cleveland
NYSTROM, U. A., The Fairfield Engineering Company, Marion

O'CONNOR, A. P., Meaden & Moore, Cleveland
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OGLE, PHILIP G., Farm Bureau Insurance Company, Columbus
O'MEARA, JOHN J., Farm Bureau Life Insurance Company, Columbus
OSTLUND, H. J., University of Minneapolis, Minneapolis, Minnesota
OSTRANDER, LEON E., Keller, Kirschner, Martin & Clinger, Columbus
OVERMAN, JOSEPH, Willys-Overland Motors, Inc., Toledo
OVERMYER, HUBERT C., Ernst & Ernst, Cleveland
OVERMYER, WAYNE S., University of Cincinnati, Cincinnati

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PALMER, JAMES E., Gold Prize Coffee Company, Columbus
PARENT, GORDON A., Aeroproducts Division, G.M.C., Dayton
PARK, LEONARD, Peat, Marwick, Mitchell & Company, Cleveland
PARKER, J. B., The International Harvester Company, Chicago
PARKER, R. ALLAN, Touche, Niven, Bailey & Smart, Dayton
PATON, W. A., University of Michigan, Ann Arbor, Michigan
PATTERSON, WM. H., The Ohio Fuel Gas Company, Columbus
PATTERSON, WILLIAM S., Goodyear Tire & Rubber Company, St. Marys
PEARCE, HARRY T., Aeroproducts Division, G.M.C., Dayton
PERKINS, CHARLES A., Arnold, Hawk & Cuthbertson, Dayton
PERKINS, R. L., Touche, Niven, Bailey & Smart, Dayton
PFLUEGER, J. A., State Teachers Retirement System, Columbus
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PLAGEMAN, LEE W., The B. F. Goodrich Company, Marietta
PUUTIO, ARNIE E., International Harvester, Richmond, Indiana

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Reilly, Edward T., Youngstown College, Youngstown
Reimer, Clarence F., Western Reserve University, Cleveland
Rhoads, I. Charles, Ernst & Ernst, Columbus
Richey, Harry H., Farm Bureau Mutual Automobile Insurance Co., Columbus
Ridgeway, George J., Wean Equipment Corp., Cleveland
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Robertson, Joseph W., Columbus
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Robinson, Howard F., Keller, Kirschner, Martin & Clinger, Coshocton
Roche, Quentin, University of Dayton, Dayton
Romei, Julius, Newark
Rosenkampff, Arthur H., New York University, New York City
Roth, Gordon A., Willys-Overland Motors, Inc., Toledo
Royer, William F., Haskins & Sells, Detroit, Michigan
Ruff, M. R., Altens Foundry & Machine Works, Inc., Lancaster
Ruhrmund, Ray D., The Hydraulic Press Mfg. Company, Mt. Gilead
Russell, Donald M., Lybrand, Ross Bros. & Montgomery, Detroit, Michigan

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